

Some Legal Issues of Utility Privatisation and Regulation

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Declaration
(Regulations 3.8.7)

I hereby declare that I have composed this thesis and this work is my own.

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ABSTRACT OF THESIS (Regulation 3.5.10)

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This thesis intends to discuss some legal issues of utility privatisation and regulation. The starting point is that the sale of electricity, gas, telecom and water companies is a special case: utilities are indispensable and must be regulated after the disposals. The thesis will concentrate on two countries in Europe: the UK and Hungary - these countries have privatised more utilities than other European governments. The discussion will make six general points which may be summed up as follows:

- 1./ So far as the utilities sector is concerned, privatisation is NOT the antithesis of nationalisation: the state does not withdraw from the provision of telecommunication, electricity, gas and water services after privatisation. The Secretary of State is a key decision-maker and seems to interfere with the running of utility companies.
- 2./ The main forms of government interference post-privatisation are /i/ regulation, /ii/ residual government stakes, /iii/ Golden Shares, /iv/ Government Appointed Directors and /v/ liberalisation of utility services.
- 3./ Privatisation legislation provides that disappointed utilities or their customers may apply for judicial review. The thesis will argue that judicial review is NOT the best dispute resolution technique in Britain: as a main rule judges do not intend to be involved in the regulatory game.
- 4./ It is an open question how the overall success of a privatisation project shall be assessed. There are a number of transactions which do not live up to expectations. The thesis will consider some of them and will try to explore what alternative privatisation techniques would have been available.
- 5./ The English and Welsh electricity sector has been reorganised five years after the initial disposals: ten regional electricity companies have been taken over. The thesis will analyse the "Big REC Race" in detail.
- 6./ Utility privatisation in Central and Eastern Europe will be on the agenda in the near future. The thesis will discuss the sale of the Hungarian gas distribution companies - the main question here will be how utility privatisation may be transplanted to Central and Eastern Europe. This part of the thesis will make a number of comparative points.

Preface

This Preface will discuss the following points:

- Whether this thesis may be criticised for being 'too little, too late';
- The structure of the thesis;
- Why the term 'privatisation' is not defined; and
- Time limit.

I./ Utility privatisation - 'too little, too late' ?

The idea of submitting a thesis on the privatisation of public utilities in 1998 may come in for criticism: it is too little, too late.

Too little:

Privatisation¹ has been one of the most popular research topics over the last two decades. Libraries hold hundreds, if not thousands, of publications on disposal of state-owned assets; privatisation research centres operate throughout the world; and there are periodicals (e.g. Privatisation International) focusing on privatisation exclusively. Compared with this pile of publications, this thesis seems to be 'too little' indeed: (a) it is NOT a general treatise on privatisation; and (b) it is NOT truly international. It may be useful to explain points (a) and (b) in some detail:

As to point (a)

This thesis does not discuss privatisation in general terms; it intends to focus on disposals in the **utilities** sector. Why utilities only ? and why not something else ?

First of all, the term 'utilities' or 'public utilities' should be defined. Two definitions are available:

(1) The 'public service' approach -

Utilities are public services that are provided for everyone. Electricity, gas, roads, trains, airlines, and seaports are examples.

(2) The 'obligation to supply' approach -

Definition (1) suggests that all public services are utilities. Is this approach correct? One may argue that all utilities are public services, but NOT all public services are utilities. Compare electricity and roads. Both of them are public

¹There seems to be some uncertainty as to how this word should be spelled: privatization or privatization. This thesis will use the latter.

services: everyone may use electricity at home and can drive on motorways. Yet these two services are not quite the same. If you purchase a small cottage in a remote area of Scotland you will get a supply of electricity: the local electricity company **MUST** connect your cottage to the electricity main. But the Highway Authority would be under **NO** obligation to construct a new motorway between your cottage and M9.

The point here is that either you have the right to demand the supply of a public service or not. The electricity company is under a statutory obligation to supply you: the Highway Authority is not. While both of them provide public services, you have an enforceable right against the electricity supplier only: this is the obligation to supply customers on request.²

Thus the term 'utilities' may be defined by reference to the 'obligation to supply'. One may argue that utilities are public services **the provision of which are subject to statutory supply obligations**. Four public services satisfy this condition for the time being: electricity, natural gas (as opposed to LPG), telecommunication, and water. According to Definition (2), only these industries are utilities.

This thesis will follow Definition (2): hence it will discuss the privatisation of the electricity, gas, telecommunication and water services.

Secondly, the 'why utilities ?' question should be answered.

Compared with 'ordinary' transactions, the sale of electricity, gas, telecommunication, and water companies is a special case; and there are three reasons for this:

(1) Indispensable

The 20th century has been the century of utilities: it was only during the last eighty years that the electricity, gas, telecommunication and water networks reached virtually every household in Western Europe. As Phillips LJ noted in **Regina v. Director General of Telecommunications, ex parte British Telecommunications plc. (QBD)**, LEXIS, 20 December 1996, "... almost everyone in the United Kingdom must be a user of telecommunication services in one form or another." Every family depends on utilities for daily living today: the supply of electricity, gas, telecommunication, and water is an essential service in our society.³

(2) No choice

If you are not sure whether your local butcher stocks mad cow disease-free steaks, then you may go to another butcher of your choice. As a rule, butchers,

²See, Chapter 1., Part I., /A/, point 2., and /B/, point 2. below.

³Kerr J. in **In the Matter of Applications by Sherlock and Morris for Judicial Review (QBD)**, LEXIS, 29 November 1996.

supermarkets, fishmongers and the like are competing for consumers. And how about the electricity, gas, telecommunication, and water companies ? They were MONOPOLY suppliers in the era of nationalisation; hence they had no real competitors. It should be noted that not all monopolies are utilities. Certain non-utility industries were also turned into monopolies in Britain: train and coal are examples. As will be discussed in Chapter 2., competition was not regarded as appropriate in the era of nationalisation. There has been a shift from 'monopolisation' to competition in Europe: this tendency has reached the utilities sector recently. Chapters 2. and 4. will argue that competition is not absolutely unknown in the utilities services today. You may select your electricity, gas, and telecommunication supplier from a list of competing companies. But, and this is the point here, **at the time of privatisation** the utility industries were not competitive: as a rule, customers had no choice.

(3) Regulation

As a rule, the sale of public utilities and the reform of economic regulation intertwine. Compared to 'ordinary' retail businesses, utilities do raise a number of special questions: how much may a supplier charge for gas/electricity ? Under what circumstances may a water company refuse to supply you with fresh water ? Who should settle disputes between customers or would-be customers and utilities?

At privatisation these issues were not new, of course. The nationalised telecommunication, electricity, gas and water boards had ready-made answers to all these questions. Yet the designers of privatisation believed that some of those answers should be reconsidered prior to offering utilities for sale. Hence existing regulatory arrangements were reformed in Britain and a new regulatory regime was introduced in Hungary. There is little doubt then that a thesis on the privatisation of public utilities must discuss the issue of post-privatisation regulation.

The three points mentioned above (i.e. (1) indispensability; (2) no-choice; and (3) regulation) distinguish utility projects from other privatisation transactions. It is one of the main themes of this thesis that points (1) - (3) pose certain questions that do not arise in the case of 'ordinary' transactions. And this is the answer to the 'Why utilities?' question: a thesis concentrating on the disposal of utilities must address some specific issues a general treatise on privatisation might have missed.

As to point (b)

This thesis will not give a world-wide coverage of utility privatisation. It will concentrate on two countries: the UK and Hungary. The reasons for this may be explained briefly.

Little explanation is needed for discussing the British privatisation programme. During the long reign of the Conservative party (1979 - 1997) privatisation was unstoppable in Britain. The facts are well known: telecommunication (1984), gas (1986), water in England and Wales (1989) and electricity (1990 - 1991) were all sold to the private sector. Thus Britain has more experience with utility privatisation than any other countries in Europe.

Compared with the UK, privatisation had a belated start in Central and Eastern Europe: the disposal of state-owned assets was not on the agenda until after the late 1980s - early 1990s. The timing was perfect. Privatisation was running out of steam in the Western part of Europe; investors and advisors were vying for opportunities elsewhere. Hence this region made up for time lost quickly: privatisation proceeds rocketed in Central and Eastern Europe in the early 1990s. Hungary was ahead of other countries in this part of the world. The first privatisation deals in that country were completed as early as 1989 and a privatisation agency was up and running by 1990. The Hungarian privatisation programme entered its most radical phase in 1995: foreign investors were invited to purchase majority stakes in the country's electricity and gas distribution networks. No Central and Eastern European country has followed suit as of today: no other government has privatised energy **distribution** systems in the region. Thus British experience with privatising utilities may only be compared with that of Hungary in the Central and Eastern European region.

To conclude, this thesis intends to research a tiny area of privatisation: it will be concerned with the sale and regulation of public utilities in Britain and Hungary. Is not this topic too restricted, or 'too little' ? Perhaps not. I believe that a Ph.D. candidate may not dream of a better subject: utility privatisation (i) is important (see Kerr J.'s point above) and (ii) has not received sufficient academic attention in the past. The latter point will be explained a little further below.

Too late

Utility privatisation is a closed chapter in Britain: as was mentioned above, electricity, gas, telecommunication, and water companies were privatised between 1984 and 1996. Whether the order of disposals - i.e. 1./ telecommunication (1984), 2./ gas (1986), 3./ water⁴ (1990), and 4./ electricity (1991 - 1992) - was accidental will be discussed in the Conclusion.

The sale of public utilities is at a quite advanced stage in Hungary: the national telecommunication company (MATÁV) was privatised in 1994, the electricity and gas⁵ sectors in 1995. Is not it 'too late' then to submit a thesis on utility privatisation now ? Certainly not, and there are three reasons for this:

⁴England and Wales ONLY.

⁵See Chapter 6. above.

(1) Legal analysis of utility privatisation ignored

It was mentioned above that privatisation is a quite well researched subject: books, reports, articles etc. discussing the sale of state-owned companies are not in short supply. It is less well-known, perhaps, that the vast majority of these publications comes from economists or from politicians. For example, Vickers and Yarrow concluded in *Privatization: An Economic Analysis* (1988) that, as far as **economic** efficiency is concerned, privatisation is not necessarily superior to public ownership. Dennis Swann raised further doubts about the **economic** rationale for privatisation in *The Retreat of the State* (1988). **Politicians** were in a hurry to challenge economic facts: privatisation 'propaganda' books were published. Oliver Letwin: *Privatising the World* (1988) or Cento Veljanovski: *Selling the State* (1987) are examples.

Compared with economics and politics, legal issues of privatisation were all but ignored. *Privatising Public Enterprises* (1991) by Cosmo Graham and Tony Prosser was the first major publication from legal academics. This book is a British - French comparative study; it deals with administrative and constitutional law issues. There is no doubt that 'Privatizing Public Enterprises' established itself as one of the most authoritative publications on the subject.

Unfortunately, not many legal academics followed the example of Cosmo Graham and Tony Prosser. Leading textbooks (for example, Gower's Company Law, de Smith's Judicial Review of Administrative Action, or O'Hood Phillips Administrative Law) devote not more than one or two paragraphs to privatisation; neither the English nor the Scottish law reports contains a separate heading for privatisation. Why do not lawyers publish more on privatisation? One of the problems may be that it is not quite clear who should discuss privatisation: practising or academic lawyers? On the one hand, practising lawyers know the ins and outs of privatisation: they have no time, or do not bother, to write up their experience. On the other hand, privatisation may not be an ideal research topic for academic lawyers: the disposal of state-owned companies raises practical (as opposed to theoretical) questions.

This thesis will seek to offer the best of both worlds: it will try to build a bridge between legal practise and academics. When I started on writing this thesis I had no privatisation experience. The lack of practical knowledge turned out to be the biggest stumbling block. I was lucky enough to be offered a consultancy post with *Clifford Chance* in 1992; subsequently I joined *N.M. Rothschild & Sons Ltd.* (1994). Both of these firms were advising the Hungarian government in connection with the restructuring and privatisation of the country's gas sector. Chapter 6. and the Conclusion draw on my privatisation experience. It is hoped that this 'bridge' between academics and practice will help to gain a better understand of utility disposals.

(2) Points never tested

It was mentioned above that privatisation and regulation intertwined in the UK and Hungary. The fact that the introduction of a new regulation regime must precede utility privatisation was generally accepted in both countries. Yet an important question was omitted, perhaps: How closely linked regulation and privatisation are exactly? May the existing system of regulation be reformed without privatisation? Unfortunately, neither the British nor the Hungarian government considered whether 'old' utilities may be subjected to 'new' regulation without privatisation. As will be discussed below, public utilities were sold off straightaway after the setting up of new regulatory regime. For example, the first 'modern' utility regulator, OFTEL, was established under the Telecommunications Acts 1984; the first tranche of British Telecommunication shares was offered for sale in the same year. The Gas Act 1994 called for the setting up of the Energy Office in Hungary⁶: the country's electricity and gas companies were privatised in 1995. Perhaps a historic opportunity was missed in both countries: public utilities might have been subjected to a new style of economic regulation (like RPI-x) BUT retained in the public sector.

(3) Transplantation of utility privatisation

Utility privatisation is a piece of industrial history in the UK. Yet there are countries which are expected to start the disposal of electricity, gas, telecommunication, and water companies in the near future. Russia, the Czech Republic, and Romania are examples. It will be one of the main themes of this thesis that these countries should analyse the relevant British and Hungarian projects *prior to* offering utilities for sale. There are so many lessons to be learned; the Conclusion will set out the most important issues would-be vendor governments may wish to consider.

To sum up, it is not 'too late' to submit a thesis on utility privatisation. First of all, it is open to debate whether this topic has received sufficient academic attention in the past. Secondly, the British model of utility privatisation and regulation may be transplanted into a number of Central and Eastern European countries in the near future. Thus it may be the right moment to finalise a British - Hungarian comparative analysis on the sale of electricity, gas, telecommunication, and water companies.

II./ Structure of the thesis

This thesis contains six Chapters. Each Chapter has (i) a general Introduction, (ii) a number of Parts discussing specific issues in detail, and (iii) a Conclusion. Some

⁶See Chapter 6., point 1.5.

comparative points concerning the transplantation of utility privatisation are re-stated in the final Conclusion.

The six Chapters may be divided into two groups:

- The first three chapters will make general points:

Chapter 1. will compare economic regulation in the era of nationalisation and after privatisation. The discussion will focus on (i) price control, (ii) obligation to supply, and (iii) consumer protection. It will conclude that privatisation was not a fresh start in the UK; so far as regulation is concerned, privatisation may be seen as the continuity of nationalisation. This Chapter will also argue that the idea of government 'control' was not buried after privatisation. Actually, the Secretary of State may, and does, interfere with the regulation of privatised utilities.

Chapter 2. will explore the issue of post-privatisation interference further. It will be argued that the UK government had a number of legal mechanisms for controlling privatised companies: (i) residual government stakes, (ii) so-called Golden Shares, and (iii) government appointed directors are examples. This Chapter will analyse why techniques (i) and (iii) disappeared in Britain; and why Golden Shares (point (ii) above) are so popular in the post-privatisation phase. The legal nature of this control mechanism will be examined next; then the discussion will go on to discuss the reception of Golden Share in Hungary. Furthermore, this chapter will argue that the liberalisation of the UK utilities sector was a government-managed process: it was the competent Secretary and State (as opposed to the Directors General) who phased in competition in the electric, gas, and telecommunication industries. Details of this process will be discussed in Part IV. of this Chapter.

Chapter 3. will be concerned with the judicial review of regulatory decisions. The main point here will be that, although there might be more applications for judicial review in the future, the judiciary will not meddle with the regulation of privatised utilities: successful applications for judicial review will be more the exception than the rule. The last Part of this Chapter will present an economic model of making applications for judicial review: it will conclude that, compared with judicial review, arbitration may be a better dispute resolution technique.

- The last three chapters will focus on concrete projects:

Chapter 4. will analyse how the success of privatisation may be assessed. It will be argued that the achievements of privatisation shall be tested against its objectives. The Introduction will conclude that there were three objectives in Britain: (a) maximizing revenue; (b) extending share ownership; and (c) improving economic performance. In examining objective (a) it is

indispensable to refer to certain non-utility projects. It will be argued that the 'maximizing revenue' objective was ignored in the case of the (i) British Coal - , (ii) Plant Breeding Institute - , and (iii) trust port - projects. Part II. will address the 'extending share ownership' objective. The discussion will conclude that privatisation did not change the basic pattern of shareholding in Britain. Finally, Part III. will be concerned with the 'improving economic performance' objective. The main point here will be that it was competition (and not privatisation) which had the biggest impact on the performance of privatised utilities. Privatisation *without* liberalisation and restructuring will not meet the 'improving economic performance' objective.

Chapter 5. will address post-privatisation restructuring in the English and Welsh electricity sector. It will be argued that the structure of this industry was rearranged *spontaneously* between 1995 - 1996. The government retained time-limited Golden Shares in the regional electricity distribution companies: once these shares expired the 'Big REC Race' was inevitable. And, finally,

Chapter 6. will concentrate on the privatisation of the Hungarian gas distribution companies. Parts I. and II. will be concerned with pre-privatisation reforms, restructuring and the like. Post-privatisation experience will be discussed in Part III. This Chapter will make a number of comparative points in connection with utility privatisation projects in other ex-CMEA countries.

III./ No definition

The term 'privatisation' is not defined in this thesis and this is for the following reasons.

Privatisation is a quite flexible concept: for example,

- (a) the sale of council houses;
- (b) the contracting out of garbage collection; and
- (c) the relaxation of licensing arrangements in the energy industry

are all labelled as 'privatisation'. What do points (a) to (c) have in common ? Nothing: local councils sell flats to tenants in the first example, but no ownership is transferred to the private sector in examples (b) and (c). The state or a local council ceases to provide a public service in example (b), but this is not necessarily the case as far as licensing in the energy sector (example (c) above) is concerned. The fact that, for example, private petrol stations may be licensed does not imply that the state will withdraw from the retail petrol business: state-owned and private stations may and will compete after liberalisation. Thus the word 'privatisation' may not be defined easily: it refers to a number of activities which do not seem to have anything in common.

Yet some academic writers disagree; they believe that privatisation may be defined in general terms. Four definitions may be quoted here:

According to Cento Veljanovski,

To privatise is to render private or to bring into the private sector. . . .
[privatisation is] the withdrawal of the state from the production of
goods and services.⁷

Brian McBeth writes that

Privatisation entails change of ownership. Most people agree that
privatisation takes place if property is transmitted wholly or partially
from ownership of the state into that of the private sector.⁸

A publication from The World Bank argues that

Privatisation can generally be defined as any measure resulting in the
transfer from the public to the private sector of ownership or control
over assets or activities.⁹

And, finally, Dennis Swann presents the following definition:

As an umbrella term, privatisation can best be defined as the
introduction into the public sector, or what has previously been the
public sector, of conditions which typify the private sector.¹⁰

Although the four definitions quoted are as general as they could possibly be, their
validity may be questioned:

- **Veljanovski** - definition

Privatisation may not reduce the level of state involvement in the production of
services at all. See the petrol station example above or the discussion on the
regulation of utilities in Chapter 1. below.

- **McBeth** - definition

Privatisation does not entail change of ownership in the case of examples (b) and
(c) above. The contracting out of garbage collection, the relaxation of licensing
arrangements and the like belong to the 'non-divestiture subset' of privatisation.

⁷Cento Veljanovski: *Selling the State* (1987), page 2.

⁸Brian McBeth: *Privatisation. A Strategic Report* (1996), page 5.

⁹Pierre Guislain: *Divestiture of State Enterprises* (World Bank Technical Paper No. 186.) (1992),
page 1.

¹⁰Dennis Swann: *The Retreat of the State* (1988), page 2.

- **Guislain and Swann** - definitions

The following example may help to explain why these definitions may not work:

The Hungarian government sold (a) two electricity distribution companies to Electricité de France (EdF) and (b) two gas distribution companies to Gaz de France (GdF) in 1995. EdF and GdF are not private investors: they are (a) 100% state-owned utilities and (b) adamantly opposed to privatisation and liberalisation. Yet the sale of electric and gas utilities to French nationalised enterprises was privatisation: both the Hungarian and the French governments, investors, advisors etc. referred to these deals as 'privatisation projects'. These transactions defy the Guislain and Swann definitions: (a) no ownership or control was transferred from the public to the private sector and (b) it is doubtful whether GdF/EdF will introduce conditions 'which typify the private sector'.

Thus the four definitions quoted above do not seem to work: it is a futile attempt to search for a *general* definition of privatisation.

One may be tempted to argue that utility privatisation is actually de-nationalisation: what the state acquired either through purchase (UK) or through confiscation (Hungary) is sold back to the private sector. As a rule, public utilities were all nationalised in Europe: in Britain telecommunication was taken into public ownership in 1896, natural gas in 1946, electricity in 1948, and water in 1974. So far as Hungary is concerned, all the sectors listed here were nationalised between 1912 (telecommunication) and 1948 (communist take-over). It will be one of the main themes of this thesis that this approach does not work. The term, de-nationalisation, is misleading. As will be explained in Chapter 1., utility privatisation is NOT the opposite of nationalisation. While the government does offer for sale shares in telecommunication, electricity, gas and water companies, Ministers and Regulators tend to 'fiddle' with the operation of utilities after privatisation. It would be naive then to claim that utility disposals simply 'undo' what was 'done' (a) between 1896 and 1974 in Britain or (b) between 1912 and 1948 in Hungary. Hence it may not be a good idea to define 'utility privatisation' by reference to 'nationalisation'.

What may be stated in lieu of a proper definition is that **utility privatisation is the sale of state-owned shares to investors (including foreign states - see the EdF/GdF examples above). Compared to ordinary disposals, utility privatisation is a special case: the vendor (state) retains the right to interfere with the operation of businesses sold (utility companies) for an unlimited period of time (regulation).**

IV./ Time limit

The Labour Party was in opposition between 1979 and 1997: party members had plenty of spare time to make declarations about the future of privatised utilities. Initially, the Labour Party pledged to

return to public ownership the public assets and rights hived off by the Tories, with compensation of no more than that received when the assets were denationalised.¹¹

A number of less radical proposals were also made: for example, (a) 'stakeholderist legislation' shall be introduced to cover such areas as two-tier boards¹²; and (b) the timing of the liberalisation of the domestic gas market will be reviewed.¹³ It is not absolutely clear at present whether the new government will remember these promises; and, if yes, what steps (if any) will be taken.

It is beyond doubt that the Labour government will not seek to re-acquire public utilities 'hived off by the Tories'. It is also clear that the new government is likely to exercise greater control over the running of utility companies: regulation will be reformed in Britain. The President of the Board of Trade made the following statement in the House of Common on 30 June 1997:

I am announcing today an inter-departmental review of the regulation of the utility industries. My aim is for the review to report to Ministers by the end of the year.

[. . .]

The terms of reference for the review are to consider whether changes are required to the system of regulation of the utility industries in order to ensure open and predictable regulation, fair to all customers and to shareholders, and which promotes the Government's objectives for the environment and sustainable development, whilst providing sufficient incentives to managers to innovate, raise standards and improve efficiency.

The review will concentrate on the regulation of gas, electricity, telecommunications and water in the context of the development of competition in the regulated markets, and against the background of general competition law, where we will be legislating in the autumn. It will also consider whether there are lessons to be learnt from this and other regulatory experience, to inform the development of regulatory principles of general applicability.

¹¹See, for example, British Telecommunication: Offer for Sale of Ordinary Shares (1984), page 6.

¹²The Sunday Times, 10 August 1997, Section 3, Business, page 2.

¹³Energy Utilities, April 1997, page 3.

In short it is time to take stock to see how the existing framework can be updated, modernised and refreshed.

Arms length independence of regulators will be preserved, although after 13 years we need to ensure that the balance between Ministers and regulators is correct. Also, while the review will be examining the formula for determining prices, it will not consider rate of return regulation.

[. . .]

Ministers will consider advice emerging from the review in the autumn. If changes are contemplated, the Government will consult fully then.¹⁴

This thesis will discuss most of the points mentioned in the announcement quoted above. But it does not intend to address proposed amendments to public utility regulation following the review announced in June 1997. Thus the law is stated as of 1 May 1997 (i.e. change of government in the UK).

¹⁴House of Commons: Hansard, 30 June 1997, Column 21.

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Chapter 1.

Prefix: 'de-':

Nationalisation and De-nationalisation

The entry 'de-' reads in the COLLINS COBUILD English Language Dictionary as follows:

de- is sometimes added **1** to a verb, changing the meaning of the verb to its opposite. EG. . . . *nationalize* - *denationalize*. **2** . . . ¹

Did the editors of the dictionary use a good example here ? Is denationalisation the opposite of nationalisation ? These are the questions this Chapter tries to examine in some detail.

Cento Veljanovski likes the nationalisation - denationalisation example; he argues that "privatisation is the opposite of nationalisation."² Similarly, Brian McBeth writes that privatisation "is the opposite of nationalisation when the state buys assets from private owners".³ This chapter will try to offer an alternative interpretation: it will contend that, as far as regulation is concerned, denationalisation is the continuity of nationalisation. Part I. will describe briefly economic regulation (a) in the era of nationalisation and (b) after privatisation. The two systems of regulation will be compared in Part II.; the analysis will conclude that much the same regulatory principles operate today as during nationalisation. Finally, Part III. will argue that both public enterprises and privatised utilities are supposed to be run at arm's length from the government. In practice, however, ministers tend to wield more political influence than the legislator reserved for them.

It may be useful to address an introductory question: may nationalisation and privatisation be compared ? It follows from the "Incomparables cannot usefully be compared"⁴ - maxim that only one form of economic regulation is comparable with another. Were the nationalised industries subject to economic regulation which is comparable with the post-privatisation regulatory system ? Commentators are divided on this point. Ray Rees Esq., a professor of economics, writes that regulation is the main *alternative* to public enterprise⁵. His point is that regulation and public ownership are alternatives and as such do not co-exist. Similar views are expressed in a publication from The World Bank:

¹Collins Cobuild English Language Dictionary (1990), page 359.

²Cento Veljanovski: *Selling the State* (1987), page 2

³Brian McBeth: *Privatisation: A Strategic Report* (1996), page 5.

⁴Zweigert and Kötz: *Introduction to Comparative Law* (1992), page 31.

⁵Ray Rees: *Public Enterprise Economics* (1984), page 7. *Italics added.*

... public monopolies were not regulated prior to divestiture, precisely because they were public and somehow expected to pursue the public interest.⁶

Professor Cento Veljanovski also asserts that the economic regulation of public utilities is "a relatively new phenomenon in Britain."⁷ He analyses the history of the British privatisation programme on the understanding that "with privatisation comes regulation"⁸: regulation is a 'by-product' of utility privatisation. The above quoted sources appear to suggest that nationalised industries were not regulated. If that point were correct no comparative research may be pursued here.

Yet studies on British industrial history show that the introduction of economic regulation preceded privatisation: monopoly suppliers had been traditionally subject to some form of regulation.⁹ The British Electricity Authority noted in a HC paper that electricity prices had been regulated through the various Acts and Orders under which the undertakings operated.¹⁰ The gas industry had similar regulatory arrangements: maximum price for gas was set in the individual Acts of Parliament authorising the establishment of local gas companies.¹¹ Sir Norman Chester writes that statutory control of gas and electricity charges "had been in existence for a very long time and [after nationalisation] the Minister of Fuel and Power was only exercising a well-recognised function."¹² Sir Christopher Foster notes that the earliest examples of economic regulation date back to the 18th century. The scope of enterprises subject to regulation extended to toll roads, canals, water, railways, gas, electricity, and telephony "from soon after their commercial exploitation"¹³. A. I. Ogus goes further and points out that the first signs of economic regulation could be traced back as early as the Tudor and Stuart periods.¹⁴ Thus monopolies had been regulated well before they were taken into public ownership. Regulatory principles changed after nationalisation; but, and this is the main point here, regulation was not abolished. The question whether regulation is older than privatisation may be concluded with the following comments from Professor Tony Prosser:

It would of course be quite wrong to suggest that the public corporations established as a result of the nationalizations of the late 1940s and afterwards were unregulated by law; a number of important

⁶Pierre Guislain: *Divestiture of State Enterprises* (The World Bank Technical Paper, number 186) (1992), page 17.

⁷Cento Veljanovski: *Op. cit.*, page 144.

⁸Cento Veljanovski: *Op. cit.*, Introduction, page xii.

⁹C.D. Foster: *Privatisation, Public Ownership and the Regulation of Natural Monopoly* (1992), Part 1.

¹⁰British Electricity Authority: *First Report and Statement of Accounts HC 336 1948-49*, page 62, point 321.

¹¹For a Scottish example, see: *Burgh of Hamilton: A Century of Gas Supply (1831 - 1931)* (1931), pages 20 - 21.

¹²Sir Norman Chester: *The Nationalisation of British Industry* (1975), page 717.

¹³C.D. Foster: *Op. cit.*, page 17.

¹⁴A. I. Ogus: *Regulatory Law: Some Lessons from the Past* (1992) *Legal Studies* 12 pages 1 - 19.

statutory and indeed common law principles were of importance to their operation.¹⁵

Hence the proper interpretation of events would be to claim that the Conservative party inherited a regulatory regime which was not to its taste; the Thatcher government reshaped regulation prior to the sale of utility companies. That reform represented "a considerable *institutional* innovation in Britain"¹⁶; however it was an institutional reform and not the introduction of regulation.

To sum up, the birth of economic regulation predated privatisation by centuries in the UK. Public utilities had been subject to economic regulation from the time of their commercial exploitation. Utilities remained regulated during the years of nationalisation. If it is so, that system of regulation may be compared with the post-privatisation regulatory regime.

Part I.

Two Systems of Economic Regulation Described

As a rule, three features determine the nature of any system of utility regulation: (i) Price Control, (ii) Availability of Services, and (iii) Consumer Protection.¹⁷ Thus the discussion below will cover these issues /A/ in the era of nationalisation and then /B/ in the post-privatisation regulatory regime.

/A/ Nationalisation

A.1 Price Control

Contrary to general belief, nationalisation statutes did not grant ministerial control over tariffs¹⁸. The general theory underlying the drafting of nationalisation measures was "that Ministers should not get involved in fixing the prices charged by the Boards."¹⁹ In theory, Area Gas Boards, British Railways, the National Coal Board, statutory water companies, and the like were their own masters in setting tariffs.²⁰

The lack of legislative provisions, however, did not free nationalised industries from ministerial intervention. As a rule, ministers did not give formal instructions to the boards; rather the chairmen were 'persuaded' to take this or that action.²¹ This

¹⁵Tony Prosser: *Law and the Regulators* (1997), page 41.

¹⁶Cosmo Graham and Tony Prosser: *Privatizing Public Enterprises* (1991), page 6. Italics added.

¹⁷See, for example, John Moore: *British Privatisation - Taking Capitalism to the People* In: H.M. Guide to the UK Privatisation Programme (1995), page 72.; and Matthew Bishop, John Kay and Colin Mayer (eds): *Regulatory Challenge* (1995), pages 5 - 8.

¹⁸Select Committee on Nationalised Industries: *Ministerial Control of the Nationalised Industries* HC 371-i 1967-8, paragraph 368. [hereinafter: HC 371-i 1967-68]

¹⁹Sir Norman Chester: *The Nationalisation of British Industry* (1975), page 701.

²⁰See, for example, Section 37(8) of the Electricity Act 1947; Section 53(4) of the Gas Act 1948; or Section 2. of Public Utility Transfer and Water Charges Act 1988.

²¹The method of 'persuasion' is discussed in William Ashworth: *The State in Business* (1991), pages 84 - 85.

procedure was labelled as the 'early warning system'.²² Informal consultation became the rule later: the government declared in the 1961 White Paper that "ministers must always be consulted about any proposed substantial price change."²³ Different industries had consultations with different 'sponsoring departments': tariff increases were not co-ordinated. The lack of co-ordination was evident, for example, in the 'Danish bacon' scandal of 1949.²⁴ As the Select Committee on Nationalised Industries noted the "the application of pricing policies to the various industries appears to have been ad hoc rather than in conformity with any common principle."²⁵

Thus two points characterised price regulation after nationalisation: (i) Ministers exercised "powers not given them by statute"²⁶; and (ii) the early warning system operated on an *ad hoc* basis.

Against those shortcomings, a major achievement should also be noted: nationalisation was the most important step towards rationalisation of tariffs in the electricity and the gas sectors. According to D. J. Bolton, more than six hundred authorised undertakings supplied electricity in 1938; between them they used 102 different tariffs.²⁷ He argued for the introduction of uniform electricity tariffs as follows:

Different types for different purposes, no doubt, there must be, and different values perhaps, when costs vary appreciably; but if most of London, for example, can be served with two gas prices there should be no need for a hundred odd electricity prices. No wonder the laymen gives up in disgust any attempt to understand it, and concludes that electricity differs from everything else not in what it is but in how it is run.²⁸

Nationalisation would have been an ideal occasion for tariff unification. When the hundreds of undertakings were re-organised into fourteen area boards²⁹, the 'hundred odd electricity prices' could have been replaced with standard tariffs. While standardisation of tariffs was one of the primary goals of the 1947 legislation³⁰, no nation-wide flat rates had been introduced in the electricity sector. According to the

²²HC 371-i 1967-8, paragraph 374.

²³William Ashworth: *The State in Business* (1991), page 85.

²⁴Denmark and the UK were negotiating the long term prices of Danish bacon, butter, and eggs. The Danish delegation asked the UK partners to indicate the likely trend of British coal and iron/steel prices. The British negotiator told the Danish government that there was no indication of any increase in the price of coal. The inevitable happened: import coal prices were increased by more than 10% within a week. Source: Sir Norman Chester: *Op. cit.*, pages 723-724.

²⁵HC 371-i 1967-8 paragraph 370.

²⁶Ray Rees: *Public Enterprise Economics* (1976), page 5.

²⁷D.J. Bolton: *Costs and Tariffs in Electricity Supply* (1938), Preface

²⁸D.J. Bolton: *Op. cit.*, pages 205 - 206.

²⁹First Schedule to the Electricity Act 1947.; or *Electricity Supply Industry in the UK. A Chronology* (1982), page 42. The fifteenth entity was the North of Scotland Hydro Electric Board which operated under a separate Act of Parliament of 1943.

³⁰Section 1(6)(d) of the Electricity Act 1947.

British Electricity Authority, complete national uniformity of charge was neither practicable nor desirable.³¹ In practice, different Area Boards paid different tariffs to the Authority; and the same Area Board charged different tariffs to different consumers. It was Section 37. of the Electricity Act 1947 which explicitly provided for such price differentiation: actually, the application of the same charge per unit on all consumers would have been contrary to the Act.³² Similar developments happened in the gas industry: under the 1948 Gas Act twelve area boards had been established; different boards fixed different prices by reference to parts of their areas.³³ No uniform standing charge was introduced either: it depended on the size of the consumer's house³⁴.

The Court of Session analysed the legality of price differentiation in the British Oxygen - litigation.³⁵ The basic facts of this case may be summarised as follows: The South of Scotland Electricity Board charged a cheaper tariff for high-voltage supply and a higher tariff for low-voltage supply. The Board increased the basic charge of electricity on two occasions; the same 'fuel variation clause'³⁶ was applied to both categories of supply. British Oxygen, a high-voltage consumer, averred that the electricity board exercised undue discrimination against high-voltage consumers: different variation clauses should have been applied to the different categories of consumers to reflect differences in the costs of electricity generation. The court accepted this argument in principle; the final judgement declared that where an Area Board showed an undue preference contrary to the Electricity Act 1947 aggrieved consumers may bring an action to recover the excess or overcharge.

An additional point should be noted here: the court expressed its willingness to participate in the regulatory game. Lord Justice Clerk (Thomson) declared that the Court is competent to ascertain the amount of overcharge and argued that

It is the sort of thing that the Courts do daily in all kinds of cases. [...] The inquiry as to what, had the defenders obeyed the statute, would have been a fair charge is one which the Court can conduct on material relevantly put before it.³⁷

Chapter 3. will argue that this judicial attitude to regulatory issues is a piece of legal history in Britain; judges seem to give price regulation a wide berth nowadays.

To summarise, electricity and gas tariffs were rationalised but no nation-wide flat tariff was introduced after nationalisation.

³¹British Electricity Authority: First Report and Statement of Accounts HC 336 1948-49, page 70, point 362.

³²**British Oxygen co. Ltd. v. South of Scotland Electricity Boards and ors.** 1958 S.L.T. 113., at 126.

³³Third Schedule to the Gas Act 1948: Code of Provisions Relating to Gas Supply, Section 17(2).

³⁴**London Electricity Board v. Springate** [1969] 1 W.L.R. 524

³⁵**British Oxygen co. Ltd. v. South of Scotland Electricity Boards and ors.** 1955 S.L.T. 306., 1956 S.L.T. 278, and 1958 S.L.T. 113.

³⁶See Part II., Cost pass-through above.

³⁷at 124.

A.2 Availability of Services

Public corporations, being the 'high custodians of the public interest'³⁸, were not expected to make surpluses. A wide variety of so-called 'social obligations' did a lot to make sure that the industries would not do so. Goods and services in this category were usually unremunerative from a commercial point of view. Nonetheless the nationalised industries produced or provided them because of their social content³⁹.

The primary source of social obligations was the statute books. The Electricity Act 1947 and the Gas Act 1948 imposed a statutory duty on the electricity and gas enterprises to supply rural areas and to respect amenity interests⁴⁰. In the case of gas, Section 8. of the 'Code of Provisions relating to Gas Supply' explicitly provided that customers shall be supplied on request. Similarly, the electricity Area Boards were required "to carry out an efficient and economical distribution of those [i.e. electricity] supplies to persons in their area who require them."⁴¹ It is the 'obligation to supply'. As was mentioned in the Preface, this obligation is truly peculiar to the utilities sector. The following example might help to explain what the 'obligation to supply' actually means:

If you own a small restaurant, you may refuse to serve certain customers: notices like 'No football fans', 'No bow ties' are examples. Provided that your notices comply with 'generally accepted standards'⁴², it is quite likely that nobody will challenge your 'business policy' - disappointed would-be patrons will go somewhere else for a meal.

The situation is completely different in the case of public utilities. A utility may not issue notices. As a rule, existing customers shall be supplied; would-be customers shall be connected and supplied. If a request for supply is not honoured, the would-be customer may take the utility to court; and it will be up to the utility to justify the non-provision of services. **Regina v. Director General of Gas Supply, ex parte Smith and another (QBD)**, LEXIS, 31 July 1989 (see Chapter 3.) and Woodcock (see below) are examples.

Comparing the restaurant with the utility company, two points should be underlined:

1./ You will not be taken to court if football fans are not served in your restaurant. If a request for supply is refused, the utility **MUST** explain why a customer has been (a) disconnected or (b) not connected.

2./ You may change your 'business policy' at any time: new notices may be put on the door as and when you think fit to do so. The utility may not amend the

³⁸Lord Morrison of Lambeth: Socialisation and Transport (1933), page 157.

³⁹HC 371-i 1967-8, paragraph 687.

⁴⁰Ibid, paragraph 693.

⁴¹Section 1(2) of the Electricity Act 1947.

⁴²While it is hard (if not impossible) to define what 'generally accepted standards' mean, there is no doubt that notices, like 'No nigger', 'No lesbian couples' etc., are beyond the limit of such standards.

rules on, and exception to (see below), the obligation to supply. As was remarked above, such rules are set forth in Acts of Parliament; it is for the legislator (and NOT for the utility) to re-define supply obligations.

The general obligation to supply was qualified after nationalisation. The Electricity Boards could refuse an application for supply provided that the extension of the network to certain rural areas was not "practicable"⁴³. As far as the gas industry is concerned, the area boards were obliged to satisfy (i) all "reasonable" demands for gas if (ii) it was "economical" to do so.⁴⁴ Hence different let-out clauses applied in different industries.

Two reported cases concerning supply obligations may be mentioned here. Dunn J. found in **Woodcock v. South West Electricity Board [1975] 1 W.L.R. 983** that the obligation did not extend to an unlawful occupier. A Scottish Sheriff Court ruled that the duty to supply did not amount to a duty at common law to maintain an uninterrupted supply of gas.⁴⁵

The main points to conclude here are as follows: (a) gas and electricity boards were generally obliged to supply customers under the nationalisation Acts; (ii) the obligation to supply was subject to different conditions in different industries; and (iii) enterprises were not obliged to maintain an uninterrupted supply.

A.3 Consumer Protection

Promoters of the British nationalisation programme argued that consumers would benefit from the taking into public ownership of telecommunication, gas, electricity and water companies. To put it bluntly, nationalisation tried to convert public utilities into non profit directed entities. Nationalised industries were expected (i) to provide services to the public and (ii) to think only of customers but (ii) NOT to seek to earn profits. Thus consumer councils were established under the relevant nationalisation Acts with the declared intention to look after the interests of consumers. Yet two points should be considered in connection with consumer protection:

- (i) Both the structure and the titles of the consumer councils varied from industry to industry. As the Consumer Council noted "... a whole variety of consumer organisations of one sort or another was established"⁴⁶. For example, two councils were set up under the Coal Act 1946; the Industrial Coal Consumers' Council and the Domestic Coal Consumers' Council.⁴⁷ Statutory consultative machinery had a different structure in the electricity and gas industries: one

⁴³Section 1(6)(b) of the Electricity Act 1947.

⁴⁴Section 1(1)(9) of the Gas Act 1948.

⁴⁵**John C. Dalziel (Airdrie) v. Burgh of Airdrie 1966 S.L.T. (Sh. Ct.) 39**. A comparative comment: suppliers are generally obliged to maintain a safe and uninterrupted supply on the Continent. See, for example, Section 387. of the Hungarian Civil Code (Act IV. of 1959).

⁴⁶Consumer Council: Consumer Consultative Machinery in the Nationalised Industries (1968), page 1.

⁴⁷Section 4 of the Coal Industry Nationalisation Act 1946.

consultative council was established for each area board⁴⁸. A third model was introduced under the Post Office Act 1969: a national council (Post Office Users' National Council) and three country councils were established. The operation of those councils was also supported by some 200 Post Office Advisory Committees which were concerned with postal and telecommunication matters at local level.⁴⁹ This system of consumer protection was a jungle for the consumer: it was quite difficult to find the competent agency.

- (ii) The general public did not know much about the consumer councils. The principal problem here was that "the councils have done little to publicise themselves."⁵⁰ A survey from the Consumer Council revealed that 12% only of the sample was aware of the electricity councils in 1968;⁵¹ and the electricity councils were not among the least known consultative bodies.⁵² The situation did not change much by 1976: the newly established National Consumer Council reported that consumer councils were literally unknown to the majority of the public. Local municipalities handled more consumer complaints than the consumer protection agencies.⁵³

Why was no action taken to improve the notoriously dismal operation of consumers councils? Kelf-Cohen offers a blunt, but perhaps correct explanation: "Nationalisation was not intended to benefit the consumers."⁵⁴ Nationalisation Acts were not amended, although members of the Parliament received rather critical reports about the work of consumer agencies⁵⁵. Without statutory changes recommendations from the National Consumer Council and from the Select Committee remained potential solutions only.

To summarise, consumer protection received much publicity as an argument in favour of taking monopolies into public ownership. But the nationalisation Acts failed to put in place an operative system of consumer protection. The performance of consumer agencies had been unsatisfactory; nonetheless, no reform followed.

⁴⁸Select Committee on Nationalised Industries: Relations with the Public HC 514 1970 - 71, pages xviii - xix, and xxiv. [hereinafter: HC 514 1970-71]

⁴⁹See: HC 514 1970-1, pages vi - xxxi. and Brian W. Harvey, *The Law of Consumer Protection and Fair Trading* (1982), Chapter 4.

⁵⁰Acton Society Trust: Relations with the Public (1953), page 21.

⁵¹Consumer Council: Consumer Consultative Machinery in the Nationalised Industries (1968), page 32.

⁵²Consumer Council: op. cit., page 50.

⁵³Consumer Council: Consumer Consultative Machinery in the Nationalised Industries (1968); HC 514 1970 - 71; and National Consumer Council: Consumers and the Nationalised Industries (1976).

⁵⁴R. Kelf-Cohen: *Twenty Years of Nationalisation* (1969), page 266.

⁵⁵HC 514 1970 - 71 and National Consumer Council: Op. cit.

B.1 Price Control

The Conservative government, influenced by classical liberal think tanks such as the Centre for Policy Studies, condemned statutory price control in principle. But some control over certain tariffs, such as telephone, gas, railways, was thought to be desirable in order to tackle "the twin evils of monopoly - high prices and high profits"⁵⁶. Thus utility charges remained controlled after privatisation.

Probably the most widely understood point about the utility privatisation programme in Britain is that tariffs are calculated by reference to a price formula. An average newspaper reader might also be aware that the formula mentioned is linked to the Retail Price Index (RPI). Yet should a member of the public try to find the formula that venture would be no less circuitous than the quest for the Holy Grail in the tales of King Arthur.

As a rule, privatisation Acts do not seem to say very much about price formulae. Broad principles as to pricing policy are set forth in the statutes⁵⁷, but statutory references are made neither to the actual formulae nor to the applicable regulatory lags.⁵⁸ The point is that the RPI-X price cap is not enshrined in the legislation⁵⁹; hence the RPI-X method has "no formal legislative status"⁶⁰.

As a rule, restrictions on price increases are incorporated into the licences⁶¹. A licence has two basic functions: (i) it authorises a company to carry out certain activities; and (ii) it sets forth terms and conditions for the licence holder. The price formula is one of the licence conditions; perhaps the most important one.⁶² The future profitability of public utilities mainly (if not exclusively) depends upon the applicable price regime; that point alone would justify their being in the statute book. Why is it not the case in Britain ?

⁵⁶Cento Veljanovski: *Selling the State* (1988), page 156.

⁵⁷For example, Section 14 of the Gas Act 1986; Section 18 of the Electricity Act 1989. The Telecommunications Act 1984 does not contain separate sections on fixing of tariffs.

⁵⁸For example, Section 44(2) of the Electricity Act 1989 provides that the Director General may "from time to time" fix maximum prices.

⁵⁹National Audit Office: *The Work of the Directors General of Telecommunications, Gas Supply, Water Services, and Electricity Supply* HC 645 1995-96, page 22., point 3.23. [hereinafter: HC 645 1995-96]

⁶⁰Anthony I Ogus: *Regulation* (1994), page 311.

⁶¹See, for example: Condition 24 of the Licence Granted by The Secretary of State for Trade and Industry to British Telecommunications under Section 7 of the Telecommunications Act 1984. Different rules apply in the gas industry after the coming into force of the Gas Act 1995. See: HC 645 1995-96, page 11., point 2.19.

⁶²Price regulation is certainly the most detailed issue in the licences. For example, in the gas industry the authorisation of British Gas Corporation contains 16 conditions in total; condition number 3. (Restrictions of Gas Prices to Tariff Customers) alone makes up around 25% of the entire document. The Department of Trade and Industry: *Authorisation issued to British Gas Corporation* (1986), pages 8 - 20.

One possible reason for putting the price formula in the secondary legislation was that draftsmen were keen to reserve some leeway for regulators. As the prospectus of British Gas plc. put it,

Unlike the statutory rights and obligations, the conditions of an authorisation can, in general, be modified without further legislation, so ensuring a degree of flexibility to cater for changing circumstances.⁶³

Yet flexibility is not necessarily a good idea. If a given price formula may be amended easily then investors may fear that prices will follow political considerations. That system of price regulation would not be more satisfactory than the early warning system described above⁶⁴: timing and level of price increases were unpredictable. Thus the privatisation Acts seek to curb the discretionary power to amend licence conditions: this point will be explored further under Chapter 3. point 3.1 (ii)(a) below. The main rules may be summarised as follows: the Directors General may only amend licences (a) with the agreement of the licensee; or (b) following a report from the Monopolies and Mergers Commission on a reference made to them.⁶⁵ The same rules apply to the modification of price formulae.

The main point to be concluded here is that price regulation is not the domain of legislation in Britain. Price formulae are published in the licences and not in the Acts. This arrangement intends to create a flexible legal environment; licence conditions may be modified without legislative approval. To avoid too much flexibility, the power to amend licences is subject to statutory restrictions.

The last issue in connection with price regulation is the structure of tariffs. It was discussed above that nationalisation did not introduce nation-wide flat rates in the electricity and gas industries: different area boards charged different tariffs. The privatisation Acts wound up the electricity and gas boards: is it to say that price differentiation disappeared in Britain ?

An introductory point should be made here. The idea of nation-wide flat tariffs seems to be incompatible with principles of 'good' pricing policy in the post-privatisation phase. While it is open to debate what 'good' pricing policy actually means, it is beyond doubt that utility tariffs shall be cost-reflective after privatisation: tariffs should cover reasonable costs. It follows from the principle of 'cost-reflective' pricing that different regions in the UK will pay different prices for electricity and gas: (i) different regions are supplied from different fields/stations and (ii) the cost of transmission varies from region to region. The logical approach would be then to claim that the

⁶³British Gas: Offer for Sale of Ordinary Shares (1986), page 32.

⁶⁴See point A. 1. above.

⁶⁵HC 645 1995-96, page 11., point 2.19. A different procedure applies in the water and sewerage industry: the Director General may determine new price limits without needing formally to amend the licence. See: HC 645 1995-96, page 12., point 2.21.

farther away a given area is from Scotland, the higher gas transmission cost will be charged.

Yet this is not what happened in the **gas** sector. British Gas plc. charged the same tariff for domestic customers in London, Cardiff, Edinburgh and other major cities in 1995.⁶⁶ Hence one may argue that UK natural gas tariffs were not really cost-reflective after privatisation: transmission costs were not taken into consideration. Professor Graham predicted in 1996 that the British gas industry will move away from 'postalised pricing'.⁶⁷ He was correct; the liberalisation of the UK gas sector has scrapped uniform tariffs in the **industrial** sector. As will be argued in Chapter 4., domestic customers may enjoy the benefits of competition from 1998 onwards. As a result, a handful of charges may be quoted for the supply of the same flat in Britain. To conclude, privatisation and liberalisation did not unify gas prices in the UK: compared to nationalisation, a wider range of tariffs are available today. More tariffs will follow after the full liberalisation of the domestic gas market. The introduction of uniform tariffs is not on the agenda in the UK gas sector for the time being.

So far as **electricity** is concerned, the starting point is that there were no postalised tariffs in this sector after privatisation. Different regional electricity companies [hereinafter: REC] charged different tariffs after 1990 (i.e. year of flotations); and there were two reasons for this:

(a) Price Formulae

OFFER set different 'X' values for different RECs before privatisation. Thus the same RPI-X - style formula produces twelve different price bands in the case of the RECs in England and Wales. There are another two price groups in Scotland.

It should be noted that the 'different 'X' for different companies' point was not relevant in the case of the gas sector. As will be highlighted in Chapter 4., British Gas plc. was privatised as a *de facto* monopoly: the same company supplied the whole UK. While British Gas plc. was sub-divided into region units for corporate governance purposes, the initial price formula was set for the company as a whole.

(b) Transmission Use of System Charge

The National Grid divided the country into a number of areas for transmission purposes; each area has a so-called Transmission Use of System Charge (hereinafter: TUC) expressed as GBP/Kwh. TUC is higher for those areas

⁶⁶The Digest of UK Energy Statistics (1996) page 117, table 58.

⁶⁷Professor Cosmo Graham: Universal Service: A Comparative Perspective In: Centre for the Study of Regulated Industries: Access Rights and Affordability (1996), page 65. and

which have insufficient power generation capacity, while TUC is low in those areas which are net power 'importers'.⁶⁸

The point here is then that, unlike in the gas sector *before* liberalisation, electricity prices vary from region to region in Britain: (a) different RECs have different price formula; and (b) the National Grid plc. charge different TUCs for different transmission areas. This is why domestic consumers pay different prices for electricity in different parts of the UK.⁶⁹

The main points concerning price regulation in the post-privatisation phase may be summarised then as follows: (i) Detailed rules on tariff regulation do not form part of the privatisation legislation: price formulae are set forth in the licences. The regulators are under no statutory obligation to continue the application of RPI-X price caps. (ii) Privatisation Acts did not introduce complete national uniformity of charges. Different suppliers charge different tariffs: there are no nation-wide, uniform utility tariffs in Britain.

B.2 Availability of Services

Those who tried to block the sale of public utilities argued that transferring gas, water, electricity, railways etc. companies into the private sector would adversely affect so-called 'social obligations'. The National Consumer Council argued that "access to water, fuel, light and so on is a basic 'right' in a modern society"⁷⁰. John Ernst writes that

Universal access to clean water and safe and reliable supplies of energy is generally recognized as one of the fundamental quality-of-life benchmarks in late twentieth century society.⁷¹

Consumer pressure groups were particularly concerned with the future of unprofitable services (rural gas/electricity services, unprofitable coach routes and railways lines etc); they feared that "privatisation could lead to consumers in rural areas, presumed to be more costly to serve, having to pay higher prices."⁷² To tackle these problems, it was essential to guarantee that 'social obligations' would not vanish after privatisation. Thus the legislator provided that privatised utilities should supply consumers on request. For example, if the owner or occupier of any premises ('relevant premises') serves a connection notice on a water undertaker the water company is obliged to connect a service pipe to Relevant Premises with one of the

⁶⁸I am grateful to Professor David Newbery (Cambridge University) for drawing my attention to TUC.

⁶⁹Digest of UK Energy Statistics (1996), page 117., table 58.

⁷⁰In the Absence of Competition (1989), page 10.

⁷¹John Ernst: *Whose Utility?* (1994), page 37.

⁷²OFGAS: *A framework for Effective Competition* (1994), point 12.5.

undertaker's water mains.⁷³ Similar arrangements apply in the case of the electricity, gas, and telecommunication industries. Lord Justice Dyson remarked in **Norweb Plc. v. Dixon (QBD)**, [1995] 3 All ER 952 that

... save in certain narrowly defined circumstances, if a consumer requests the supply of electricity, the supplier is obliged to supply.⁷⁴

What are those 'narrowly defined circumstances'? For example, British Telecommunication is obliged to provide telecommunication services which satisfy all reasonable demands, "to the extent that it is practicable to provide them"⁷⁵. An authorised gas supplier must satisfy all reasonable demands "so far as it is economical to do so"⁷⁶. In the electricity industry a request to supply may be refused if "it is not reasonable in all the circumstances for him [i.e. distribution company] to do so."⁷⁷ Provisions quoted above appear to be modelled upon the nationalisation statutes; actually, the same terms qualify the general obligation to supply under the Gas Acts of 1948 and of 1986.⁷⁸ As far as the electricity industry is concerned, Lord Justice Dyson noted in **Norweb v. Dixon (QBD)** [1995] 3 All ER 952 that

there were no provisions of the Electricity Act 1947 relied on in *Willmore* which were materially different from the 1989 Act [i.e. Electricity Act of 1989].⁷⁹

Supply obligations *did not* cause problems in the era of nationalisation: as was mentioned above, nationalised industries were not profit directed enterprises. Thus the obligation to supply remote areas, high cost customers, etc. did not bother nationalised utilities. But the economic consequences of the obligation to supply came to the forefront at privatisation. Privatised utilities, unlike their nationalised predecessors, are profit-oriented companies. Thus utilities may want to get rid of high cost, low user customers, if possible. Is there a conflict here between (a) profit motive and (b) supply obligation? Yes, according to Professor Prosser. He argues that (i)

⁷³Section 45 of the Water Industry Act 1991.

⁷⁴at 959-G

⁷⁵Conditions 1. and 2. of the Licence issued to British Telecommunications plc. See, also, British Telecommunication: Offer for Sale of Ordinary Shares (1984), page 17. The net cost of universal service obligation was between £50m and £120m in 1993 in the telecommunications industry. The latest statistics set the figure between £90m and £150m. See: The Financial Times, 8 December 1994. and Centre for the Study of Regulated Industries: Universal Service Obligations: A Policy Review (1996), page 78.

⁷⁶Section 4(1)(a) of the Gas Act 1986.

⁷⁷Section 17(2)(c) of the Electricity Act 1989.

⁷⁸In both cases the duty to supply is limited to (i) reasonable demands; and (ii) the obligation only applies if the supply is 'economical'. See Section 1(1)(9) of the Gas Act 1948 and Section 4(1)(a) of the Gas Act 1986.

⁷⁹The Times, February 24, 1995. Reference is to **Willmore and Willmore (trading as Lissenden Poultry) v. South Eastern Electricity Board** [1957] 2 Lloyd's Rep. 375.; the court ruled that the Board supplied electricity pursuant to the statutory obligation to supply, and not under a contract between Willmore and the Board.

regulators have no clear guidelines how to regulate because (ii) the government went too far in acknowledging the right of access to utility services. The best possible guideline, maximisation of economic efficiency, occupies only a secondary role. As a rule, the universal right of access to services seems to be the overriding goal of utility regulation in the UK.⁸⁰ This conflict of duties will be examined under point B.3. below.

The courts interpreted the legal mechanism underpinning 'the universal right of access to utility services' in the following cases:

- **R. v. Director General of Gas Supply & Another, ex parte Smith & Another (QBD)**, LEXIS 31 July 1989,
- **Green v. Yorkshire Electricity Group Plc. (Chan. Div.)**, LEXIS, 19 November 1991,
- **Norweb Plc. v. Dixon (QBD)**, [1995] 3 All ER 952,
- **Gwenter v. Eastern Electricity Plc. (CA)**, LEXIS 7 February 1995, and
- **In the matter of Applications by Sherlock and Morris for Judicial Review (QBD)**, LEXIS 29 November 1996.

The main points of the cases listed above may be summarised as follows:

- Suppliers are under a *statutory* (as opposed to contractual) obligation to supply customers.⁸¹ A utility must give a supply to potential *new customers*, unless (i) the supplier can point to a statutory let-out clause⁸²; or (ii) the giving of a supply would put the utility "at a risk of being prosecuted for a criminal offence".⁸³ Should a utility breach this statutory duty aggrieved customers may claim damages.⁸⁴
- An *existing customer* may be disconnected if, and only if, certain *statutory* conditions, as defined in the relevant Public Supply Codes⁸⁵, are fulfilled.⁸⁶ The most likely reasons for disconnection are (i) arrears and (ii) meter tampering. A utility may refuse to reconnect a customer "until the matter has been remedied."⁸⁷ - i.e. arrears have been paid and/or a new meter has been installed at the cost of the customer.⁸⁸ As a rule, the courts want utilities to restore the supply as soon as

⁸⁰Tony Prosser: *Privatisation, Regulation and Public Services*, in *Juridical Review* (1994), pages 6-13.

⁸¹Norweb - case; and also Harman J. in Green.

⁸²See the discussion above.

⁸³Harman J. in Green.

⁸⁴Gwenter - case.

⁸⁵See, for example, the Public Gas Supply Code, Schedule 5. to the Gas Act 1986, as amended. or the Electricity (Northern Ireland) Order 1992.

⁸⁶Waite LJ in Gwenter.

⁸⁷Schedule 6, paragraph 4 of the Electricity (Northern Ireland) Order 1992.

⁸⁸See, for example, Sherlock - , or Smith - cases.

practically possible: the preferred solution seems to be the installation of a pre-paid meter.⁸⁹

The above discussion concerning the obligation to supply *after* privatisation may be summed up then as follows: (i) Privatised utilities are generally obliged to supply consumers on request. (ii) This obligation is subject to different let-out clauses in different industries. and (iii) Utilities are under a statutory duty to provide services.

B.3 Consumer Protection

According to privatisation propaganda, regulation is for the benefit of consumers; the main purpose of the entire regulatory regime is to protect the interests of the consumers.⁹⁰ Yet consumer protection does not seem to be a particularly well elaborated aspect of the privatisation Acts. To illustrate that point the statutory standing of consumer agencies will be examined below.

Strictly speaking, only the gas industry has a consultative council established under an Act of Parliament⁹¹. Consumer bodies also exist in the water and electricity industries; but they were set up by the Directors General⁹² and are not recognised under the privatisation Acts. Thus Aileen McHarg correctly notes that "the absence of any rationalisation of consumer representation in the industries" is the most obvious aspect of the privatisation Acts.⁹³

Why does it matter whether customer agencies are statutory bodies or not ? As a rule, Directors General are under no duty to take account of representations submitted by NON-statutory bodies: that is the case, for example, in the water sector for the time being. Should the OFWAT National Customer Council [NCC] be made into a statutory body, then the DG of Water Services would be under a duty to consider representations from NCC.⁹⁴ It is of special importance then whether the existing customer protection agencies will be transformed into statutory bodies.

The worst record for consumer protection is in the telecommunications industry. The users' councils had been abolished just prior to the sale of British Telecommunication plc.⁹⁵; issues of consumer protection had been remitted to the Director General. This arrangement is unsatisfactory: remitting consumer protection functions to the Directors General may create a kind of 'conflict of interests'. On the one hand, regulators are under a statutory duty "to ensure that companies are able properly to

⁸⁹Sherlock - and Gwenter - cases.

⁹⁰For example, see the speech of M. Jack MP: Utility Regulation - A Political Perspective (1996), page 1. or OFWAT: Issues Involved in Regulation of Privatised Water Utilities (1992).

⁹¹Section 2(1) of the Gas Act 1986. and see also: Aileen McHarg: The Competition and Services (Utilities) Act 1992: Utility Regulation and the Charter In: [1992] P.L. 385, at 395.

⁹²Section 2(1) of the Electricity Act 1989; OFWAT: Water Supply, Sewage Disposal and the Water Environment (1994), page 6; and Centre for the Study of Regulated Industries & Price Waterhouse: Regulated Industries The UK Framework (1996), page 15, Point 2.4.6.

⁹³Aileen McHarg: Op. cit., at 395.

⁹⁴Press Notice PN 32/97 published in: Util Law Rev. 9(1) Jan - Feb 1998, page 21.

⁹⁵Section 49(4) of the Telecommunications Act 1984.

carry out and finance their functions."⁹⁶ On the other hand, the Directors General should protect the interests of customers. What shall a diligent regulator do if a utility wants to increase charges, while customers complain that charges are disproportionately high? There is no 'good' solution here. The best option would be if the regulators did not try to pursue conflicting statutory duties. For example, the Director General of Water Services has recommended in a submission to the government that the protection of customers shall be made his single primary duty⁹⁷; the other statutory duty (i.e. the companies shall be able to carry out and finance their functions) shall be abolished. It remains to be seen whether the Labour government will consider this submission; and, if yes, what steps will be taken to resolve this 'conflict of duties' outlined above.

A laudable attempt was made to standardise and strengthen the rights and duties of the Directors General in 1992.⁹⁸ The Competition and Services (Utilities) Act 1992 introduced identical procedures for dealing with consumer complaints in the telecommunications, gas, electricity, and water industries.⁹⁹ But the practical importance of the Competition and Services (Utilities) Act 1992 is limited: the remit of the 1992 Act is restricted to (i) standards of performance and (ii) consumer complaint procedures. Other, perhaps more important, aspects of utility regulation have not yet been harmonised. The 1992 Act could be referred to as a model should the legislator intend to unify regulatory procedures further.¹⁰⁰

As far as consumer protection is concerned, the unification of regulatory procedures should not be the most pressing issue. There are other problem areas: for example, the right of customers to seek specific performance. The point here is that the public seems to be less well served today than in the era of nationalisation. It may be useful to give a simple example here:

A construction company asks the local council to link up the ends of home drains and street gutters with an existing main sewer. The local council informs the construction company that sewers within a development area should be laid by the developers. How may this dispute be settled?¹⁰¹

Two questions shall be considered here:

⁹⁶Recent Publications, *Water In.: Util. Law Rev.*, 9(1) Jan - Feb 1998, page 21.

⁹⁷*Ibid*, pages 20 - 21.

⁹⁸Aileen McHarg: *Op. cit.*, at 385 - 396.

⁹⁹According to A. McHarg, total uniformity was not achieved; the water and telecommunication industries are subject to different duties than the gas and electricity sectors. See: Aileen McHarg: *Op. cit.*, at 390.

¹⁰⁰Whether standard procedures should apply to all regulatory offices is an open question. For example, A. McHarg argues that it would have no practical merit. See: Aileen McHarg: *Op. cit.*, at 395.

¹⁰¹*T. Docherty Ltd. v. Monifieth Town Council*, 1971 S.L.T. 13.

- (i) Whether the construction company should sue (a) the service provider or (b) the regulator ?
- (ii) May the court order the specific performance of the statutory duty to provide water and sewage services ?

The proper answers to these questions *under the nationalisation Acts* were as follows:

- There were no regulators, thus the service provider was the respondent; and
- The Court of Session had authority to order the specific performance of a statutory duty.¹⁰²

As far as *privatisation legislation* is concerned, no simple answers seem to be available. First of all, it is an open question whether customers should sue the regulated utility or the competent regulator. According to de Smith's *Judicial Review of Administrative Action*, the proper course of action would be to bring proceedings against the regulatory body.¹⁰³ But judicial review was sought against a utility (Northern Ireland Electricity) **In the Matter of Applications by Sherlock and Morris for Judicial Review**, Lexis, 29 November 1996. Kerr J. did not strike out the application as premature, although the applicants failed to seek help from OFFER (subsequently re-named as OFREG). Thus it is questionable now whether customers may seek remedy from the court directly or should appeal to the regulator first.

Assuming that de Smith is correct, i.e. customers should sue the competent regulator, the discussion on 'specific performance' may be summed up as follows: the court may not order the specific performance of statutory duties if the respondent is the regulator (as opposed to the utility). As will be discussed in Chapter 3. below, the preferred form of remedy is certiorari: the courts are reluctant to grant mandamus or declaration.

The final point here is then that, compared with the era of nationalisation, customers will find court orders less useful today. As a main rule, the courts may not order the specific performance of statutory duties under the privatisation legislation. Thus customers were better protected when Docherty was decided in 1971.

To sum up the above discussion, the currently existing consumer protection regime inherited some well-known hiccups from the past. Different industries have different patterns; the statutory standing of consumer bodies is far from being uniform. Leaving aside the Competition and Services (Utilities) Act 1992, the legislator did hardly anything to harmonise procedures of the regulatory offices. So far as specific performance of statutory duties is concerned, customers were in a better position under the nationalisation Acts.

¹⁰²See the speech of the Lord President (Lord Clyde) in Docherty.

¹⁰³de Smith, Woolf & Jowell: *Judicial Review of Administrative Action*, Sweet & Maxwell (1995), para. 3-046.

Part II.

Two Systems of Regulation Compared

Having summarised the main characteristics of the two systems of economic regulation, it would be appropriate to make some comparative points now. The comparison will follow the three conventional headings, i.e. Price Control, Availability of Services, and Consumer Protection.

1./ Price Control

- Ministers had statutory power to set prices (tariffs) neither in the era of nationalisation nor after privatisation. As a rule, the legislator delegated the right to fix tariffs to the utilities. Yet members of an elected government have a natural interest in pricing policy. The ultimate question here is how ministers may influence, or indeed control, the level of tariffs without having statutory powers to do so. The detailed analysis of this point is reserved for Part III. below.
- Neither nationalisation nor privatisation opted for the introduction of nation-wide flat tariffs. Area boards charged different tariffs in different parts of their service areas. Similarly, privatised electricity and gas suppliers may fix different prices today for different classes of consumers or in different parts of their licensed territories.

2./ Availability of Services

- As a rule, the ownership of utilities is irrelevant to their being obliged to provide services. Both nationalised and privatised suppliers shall provide gas, electricity, water and telecommunication services on request.
- 'Universal services' obligation was not quite universal under the nationalisation Acts: the duty to supply was subject to statutory exceptions. The legislator used fairly general terms, like 'practicable', 'reasonable', or 'economical', to qualify the obligation to supply. The situation is very much the same today: let-out clauses were carried forward from the nationalisation Acts. The most obvious example is the gas legislation: the Gas Act 1986 simply repeats the wording of the 1948 Act. Lord Justice Dyson noted in Norweb that, as far as the obligation to supply is concerned, the Electricity Act 1947 was not materially different from the 1989 Act. An electric company may be forced to make a supply under both statutes.¹⁰⁴

¹⁰⁴See: *Regina v. Director General of Electricity Supply, ex parte Redrow Homes* The Times, 21 February, 1995.

3./ Consumer Protection

- Although both industrial policies pledged to treat consumer protection as an issue of special attention, very little had been done in practice to protect the average gas/electricity/telecommunication/water consumer. A whole variety of consumer organisations had been established in the coal, transport, electricity, and gas industries after nationalisation. Perhaps the only common characteristic of these consumer consultative bodies was that they had limited statutory power. The overall operation of the consumer councils was disappointing in the era of nationalisation; yet privatisation Acts did not reform consumer protection. Actually, the situation changed for the worse so far as the complaint jurisdiction of consumer bodies is concerned.
- During nationalisation consultative committees could directly represent their case to the Minister who had the power to take action if he thought fit to do so.¹⁰⁵ After privatisation consumer bodies are effectively sealed off from the Secretary of State. The authority of consumer councils is limited to referring a matter to the Directors General¹⁰⁶ or to advise and to make a report to the Director¹⁰⁷. As will be argued in Part III. below, the Secretary of State is the most powerful officer in the regulatory regime; it is regrettable then that consumer protection bodies have no access to her/him.
- For the time being, the single industry regulatory offices act in a dual capacity: on the one hand, the offices are economic regulators; on the other hand, they are supposed to be involved in consumer protection matters. These two kinds of activities may not always run in the same direction. Contradictory expectations create an unenviable situation for the Directors General: whatever action the regulator intends to take, (s)he is bound to give priority to one of these interests at the expense of the other. The post-privatisation regulatory system would have a better record if the consumer protection jurisdiction of the Directors General were taken away.¹⁰⁸

The final conclusion is then that basic principles of economic regulation did not change over the last fifty years. Acts of Parliament do not set forth detailed rules on price regulation; services are to be provided universally; and a variety of bodies try to represent consumers with limited success. Thus, as far as **principles** of utility

¹⁰⁵R. Kelf-Cohen: *Twenty Years of Nationalisation* (1969), pages 268. - 269. and *Consumer Council: Consumer Consultative Machinery in the Nationalised Industries* (1968), page 11.; and also *Acton Society Trust: Relations with the Public* (1953), page 19.

¹⁰⁶Section 32(6) of the Gas Act 1986 and Section 29(3) of the Water Industry Act 1991

¹⁰⁷Sections 1. and 2. of the Electricity Act 1989.

¹⁰⁸The National Consumer Council is in favour of separating consumer protection from utility regulation. See: Aileen McHarg: *Op. cit.*, footnote no. 62.

regulation are concerned, privatisation is the continuity of nationalisation: beneath the glamour of a new institutional set-up the same old ideas reign.

Dissimilarities between the two systems may be spotted in **technical details**; especially so in the field of price regulation. It was mentioned above¹⁰⁹ that pricing policies did not follow pre-established rules during the years of nationalisation: ministers controlled tariffs on an *ad hoc* basis. Timing of price changes were unpredictable; the level of tariff increases represented what the government regarded as politically acceptable.

This system of price regulation was perhaps the biggest stumbling block to privatisation. As a general rule, if future pricing policy is uncertain, potential investors either (i) underprice utility shares; or (ii) do not purchase shares at all. Prior to the partial disposal of British Telecommunication plc. the government sought independent advice on price regulation. It was Professor Littlechild, for the time being the Director General of OFFER, who recommended the introduction of RPI-X formulae. According to Professor Graham and Prosser, Professor Littlechild believed that the primary purpose of regulation was "to protect the consumer from the adverse effects of monopoly power."¹¹⁰ But the kind of price regulation he recommended seems to benefit more the utilities than the customers; this point shall be explained in detail here.

As was discussed above, nationalised enterprises had the right to fix tariffs under the relevant Acts of Parliament. Yet in practice they could do so only with the consent of the Secretary of State: the government supervised the level of charges. Technical points, like (i) this kind of regulation was not enshrined in statutes and (ii) decisions on tariff increases were made on an *ad hoc* basis, did not matter to the average consumer: for her/him the only question was whether she/he had to pay more for telephone calls, gas, electricity, and water or not. The same approach should be correct today: from the point of view of the consumer it is irrelevant whether the government consents to new prices on a case-by-case basis or tariffs are increased pursuant to a formula. On the other hand, regulated utilities have three reasons to prefer the RPI-X formula to the 'early warning system':

- Timing of price review is known in advance

The RPI-X formula sets prices for some years in advance. Regulatory lags vary between three years in the electricity transmission industry to ten years in the water supply industry.¹¹¹ It was argued above that nationalised industries could

¹⁰⁹See Part I., A.1

¹¹⁰See comments in: Cosmo Graham and Tony Prosser: *Privatizing Public Enterprises* (1991), page 186.

¹¹¹Ray Rees and John Vickers: *RPI-X Price-cap Regulation* In: Matthew Bishop, John Kay and Colin Mayer (eds): *The Regulatory Challenge* (1995), page 375. The Director General of OFWAT actually reviewed prices in year 5 after privatisation, hence there is a five-year regulatory lag in the water supply industry.

never be sure about the effective date of tariff increases.¹¹² No such uncertainty exists after privatisation: price changes follow automatically the retail price index.¹¹³ With the help of a simple inflation forecast a regulated utility can foretell the level of future prices up until the date of the next periodic review.

Unexpected developments may happen, of course: the Directors General may initiate internal price reviews before the end of the current regulatory period¹¹⁴. Yet the regulators attempt to avoid internal reviews if possible; especially so after the 'botched' electricity distribution price review of 1995¹¹⁵.

Thus, compared to the era of nationalisation, regulated utilities can forecast the future level of prices with more confidence now.

- Cost pass-through

With the exception of the telecommunication industry, privatised utilities may pass through certain costs to the customers.¹¹⁶ The pass-through factor in the formulae is meant to cover costs over which the regulated companies have no control: the costs of fuel in electricity generation, or gas purchase prices in the gas supply industry are well-known examples. The concept of 'pass-through' is as simple in principle as complicated in practice. Professors Graham and Professor Prosser noted in 1991 that it was hard to see how British Gas plc. could be a "passive price taker" where it was the dominant buyer.¹¹⁷ The Gas Consumers Council summarised practical problems with cost pass-through as follows:

Of practical concern is the pass-through of costs of new gas as this automatic cover reduces the incentives for BG to negotiate the cheapest price for new contracts. There may even be an opportunity for British Gas to pay over the odds for gas to keep out competitors as the higher price can be passed on *automatically* to tariff customers.¹¹⁸

As far as nationalisation is concerned, cost pass-through was a political issue. While long-term supply agreements usually made provisions for a 'fuel variation charge'¹¹⁹, the government restricted the operation of pass-through clauses in the

¹¹²See the Danish bacon - scandal under Part I., A.1 above.

¹¹³Cosmo Graham and Tony Prosser: Op. cit., page 195.

¹¹⁴It happened, for example, in the Telecommunications and gas supply industries. See: Centre for the Study of Regulated Industries & Price Waterhouse: Regulated Industries: The UK Framework (1996), pages 20. and 27.

¹¹⁵See, Chapter 5., Part II., B./

¹¹⁶Centre for the Study of Regulated Industries & Price Waterhouse: Op. cit., pages 20., 27., 39., and 48.

¹¹⁷Cosmo Graham and Tony Prosser: Op. cit., page 194. It is to be noted that the cost pass-through factor in the British Gas licence was amended in 1992. See: Duncan O'Neill: Regulated Industries: The UK Gas Industry (1996), page 41.

¹¹⁸Gas Consumers Council: Annual Report (1990), page 3. *Italic added.*

¹¹⁹See, for example, British Oxygen - case in Part I., A.1. above.

1970s. For example, coal fired power stations were supplied by British Coal under long-term contracts¹²⁰, but the British Electricity Generating Board could not automatically pass through costs to the area boards. Professor Pryke writes that in the electricity industry the "unit costs had shot up, due to the steep increase in the price of fuel, but there was no compensating increase in charges due to the Government's policy of price restraint."¹²¹

The Monopolies and Mergers Commission was hostile to the idea of pass-through: the Commission warned that price variation mechanisms between the National Coal Board and the Central Electricity Generating Board might be "devices for passing on costs which might have been avoided".¹²²

Yet draftsmen of the licenses did not remember that warning: the passing on certain costs to consumers is a standard mechanism now. Hence, compared with nationalised boards, utilities appear to be better protected against raising procurement costs in the post-privatisation phase.

- Efficiency gains

Efficiency was of secondary importance before privatisation. To quote the celebrated words of Sir Norman Chester: "Efficiency was not a subject which had loomed at all large in the literature of nationalisation."¹²³ This is not to say, of course, that there was no growth in labour productivity.¹²⁴ But neither the Labour nor the Conservative government urged the industries to cut costs and tighten up efficiency: "... the Government was trying to keep men at work ... and the Boards could not, as the Steel Corporation found, rely on the support of Ministers if they tried to cut employment and raise productivity."¹²⁵ In addition to general employment policy, a practical point should also be mentioned: employees were not rewarded for improving efficiency. For example, the electricity industry reported productivity gains of 249.7% for the period between 1961/62 and 1981/82.¹²⁶ Regrettably, this improvement was not reflected in the 'salaries and earning tables' for the same period. Thus employees had no financial incentives to cut costs. Thus neither the government nor the industries were really concerned about efficiency gains in the nationalisation period.

¹²⁰See **British Coal Corporation v. South of Scotland Electricity Board 1988 S.L.T. 446** discussed in Part III. below.

¹²¹Richard Pryke: *The Nationalised Industries* (1981), page 38.

¹²²The Monopolies and Mergers Commission: *Central Electricity Generating Board HC 314 1980-1*, page 165., point 7.29.

¹²³Sir Norman Chester: *The Nationalisation of British Industry* (1975), page 1047.

¹²⁴Richard Pryke: *The Nationalised Industries* (1981), Table 13.1., page 238.

¹²⁵*Ibid*, pages 261 - 262.

¹²⁶Electricity Consumers' Council: *Labour Costs, Salaries and Earnings in the Electricity Industry* (1982), Table 14., page 12.

Public utilities went out of their way to increase internal efficiency after privatisation.¹²⁷ They had a good reason to do so: the regulator may not claw back efficiency gains realised between two price reviews.¹²⁸ Improved efficiency is actually the main source of soaring profit: for example, Anglia Water reported GBP58.7m net profit in 1988 and GBP171.3m in the first business year after disposal (1991). Scottish Hydro-Electric plc. made net profit of GBP60.3m in the last business year in the public sector (1991), and GBP122.7m the year after (1992).¹²⁹ The tables below intend to demonstrate that there was no corresponding increase in the number of units supplied. It was efficiency gains which generated hefty profits.

Anglian Water¹³⁰

Year	Water supplied	Number of employees	Length of water mains
1988	1,165m litres/day	5,181	31,063 km
1991	1,230m litres/day	4,663	32,000 km

TABLE 1. Efficiency gains: Anglian Water

Scottish Hydro Electric plc.¹³¹

Business year	Output (kWh)/member
1990/91	3.8 million
1991/92	4.2 million

TABLE 2. Efficiency gains: Scottish Hydro Electric

The final conclusion here is that it is not the customer only who may benefit from the RPI-X price scheme. Privatised companies seem to operate in a 'utility-friendly' environment: (i) the timing of tariff changes may be predicted, (ii) certain costs may be passed through to the customers, and (iii) efficiency gains may be retained in full. It is doubtful how the mentioned arrangements actually protect the consumer "from the

¹²⁷For example, one reason for the take-overs in the electricity sector was cost saving. See: Ken Bailey: A Bid too Far ? In: [1996] 7 Util LR. 134.

¹²⁸HC 645 1995-96, page 28., point 3.44.

¹²⁹Her Majesty's Treasury Guide to the UK Privatisation Programme (1995), pages 43 - 44.

¹³⁰Source: Anglian Water: Annual Report and Accounts 1987/88, and Anglian Water plc.: Annual Report 1991.

¹³¹Source: Scottish Hydro-Electric plc.: Annual Report and Summary Financial Statement 1991-92.

adverse effects of monopoly power."¹³²; the real issue may be how to protect the consumer from the adverse effects of monopoly regulation.

Part III.

Ministerial Power Overflowing

One issue has been reserved for further discussion under point 1./ of Part II. above. It was argued there that nationalisation and privatisation apply the same principles of price (tariff) regulation: neither nationalisation nor privatisation statutes authorise the Secretary of State to control prices¹³³. While utilities may fix charges, certain limitations, of course, apply: in the era of nationalisation the boards set prices with a view to guarantee that the industries will 'break even' taking one year after another¹³⁴; after privatisation price increases may not exceed the RPI-X ceiling. Thus nationalisation and privatisation Acts reflect the same legislative intention: ministers should be kept out of price regulation.

The first part of the discussion below will attempt to show that this intention did not actually bar members of the government from controlling prices in the nationalisation period. Later it will be suggested that developments might follow a similar direction in the post-privatisation regulatory regime: the Secretary of State may interfere in regulatory matters.

3.1. Ministers and the nationalised industries

Draftsmen of the nationalisation Acts rephrased the Morrison-concept of public corporation: the idea of arm's length control did not reach the statute books. For example, the Midland Bank Review remarked in connection with the Coal Industry Nationalisation Bill in 1946 that "... the [National Coal] Board will be required to act on lines approved by the minister."¹³⁵ Thus the idea of 'arm's length control' did not reach the statute book in Britain. Two questions should be addressed here:

- What powers did ministers have under the nationalisation statutes ?
- Why did the legislator abandon the idea of arm's length control ?

Both of these points shall be discussed in turn.

¹³²Cosmo Graham and Tony Prosser: *Privatizing Public Enterprises* (1991), page 186.

¹³³In connection with nationalisation see: Sir Norman Chester: *Op. cit.*, page 701.

¹³⁴The 'break even' principle is analysed in William A. Robson: *Nationalized Industry and Public Ownership* (1960), page 282. and in L.J. Tivey: *Nationalisation in British Industry* (1966), page 70.

¹³⁵Midland Bank Review, May 1946, page 8.

- Ministerial powers

Ministerial power over the boards may be analysed under two headings: (i) specific powers and (ii) the right to issue general directions.

(i) Specific powers

Specific powers covered a wide range of questions from the appointment of board members to the approval of training and educational programmes. The present discussion does not intend to address all ministerial powers in detail¹³⁶; the emphasis here is on finance and borrowings. Ministerial power in relation to these issues is summarised in the table below¹³⁷:

	Coal Industry	Transport	Gas Industry	Electricity
Financial requirement	to break even on an average of good and bad years	to break even taking one year with another	to break even taking one year with another	to break even taking one year with another
Borrowing	Minister may make advances; the Board may borrow with the consent of the Minister	the Board may borrow with the consent of the Minister and of the Treasury	May borrow with the consent of the Minister	May borrow with the consent of the Minister
Stocks	n/a	with the consent of the Minister and approval of the Treasury may issue British Transport Stocks	with the consent of the Minister and approval of the Treasury may issue British Gas Stocks	with the consent of the Minister and approval of the Treasury may issue British Electricity Stocks

TABLE 3. Ministerial powers after nationalisation

Two points should be emphasized here: (i) The break-even principle did not allow industries to make large and regular surpluses¹³⁸; the nationalised enterprises were not "profit-earning organisations"¹³⁹. These points will be discussed below. (ii) The nationalised enterprises could not borrow without the consent of the minister; stocks

¹³⁶For a detailed analysis see: D.N. Chester: *Op. cit.* and Tony Prosser: *Nationalised Industries and Public Control* (1986) pages 23-25..

¹³⁷Source: D.N. Chester: *Op. cit.*, pages 26-29.

¹³⁸HC 371-i 1967-68, paragraph 165.

¹³⁹See Lord Patrick's comments in *British Oxygen* - case, at 125.

could not be issued without the approval of the Treasury. Hence the government directly controlled the borrowings of nationalised enterprises.

(ii) General directions

In addition to the above mentioned specific powers, the minister also had the right to issue general directions to the boards. For example, Section 3(1) of the Coal Industry Nationalisation Act 1946 reads as follows:

Minister may, after consultation with the Board, give to the Board directions of a general character as to the exercise and performance by the Board of their functions in relation to matters appearing to the Minister to affect the national interest, and the Board shall give effect to any such directions.¹⁴⁰

Although general directions were hardly ever used¹⁴¹, it is this kind of power which contributed to the collapse of nationalisation in Britain.

• Farewell to the Morrison-concept

General directions were incompatible with the Morrison concept of public corporations. As Professor Prosser writes, the original model assumed that the minister was to keep out of the operation of largely autonomous industries; he "could not interfere except where there was *specific* legal provision for him to do so."¹⁴² Statutes of the 1930s honoured this principle: the minister could not address general directions to the London Port Authority, to London Passenger Transport Board, or to the Central Electricity Board. The introduction of general directions was "definitely a post-1945 development".¹⁴³ But this 'development' destroyed the original model of public corporation: first of all, (A) it turned working relations between the ministers and the industries upside down; secondly, (B) it shifted away regulation from legalism to negotiation between regulators and regulated. Both of these points should be explored in detail.

(A) Ministers and the Boards

It was the financing of nationalised boards which prompted ministers to abandon the idea of arm's length control. The starting point here is that the principle of 'breaking-even' significantly reduced the capability of nationalised industries to make provisions

¹⁴⁰Further examples: Section 7. of the Gas Act 1948; or Section 5. of the Electricity Act 1947.

¹⁴¹According to Thornwill, two such directions were issued in the late 1950s. See: W. Thornwill: *The Nationalized Industries. An Introduction* (1968), pages 36-37. It is interesting to note that the Labour governments of 1945-1951 did not issue general directions at all. See: Tony Prosser: *Nationalised Industries and Public Control* (1986), page 25.

¹⁴²Tony Prosser: *Op. cit.*, page 21. Italics added.

¹⁴³D.N. Chester: *The Nationalised Industries. A Statutory Analysis* (1948), page 5.

for capital expenditure.¹⁴⁴ Ironically, the nationalised industries found themselves unable to finance new investments exactly when expansion of services was very high on the political agenda.¹⁴⁵ Kelf-Cohen argues that massive development programmes "made self-financing impossible from the start."¹⁴⁶ As was mentioned above (point (i), Specific powers), the industries¹⁴⁷ could either borrow from the minister or raise money on the open market. Stocks issued by nationalised enterprises had been guaranteed by the Treasury and were traded on the market as a kind of gilt-edged securities.¹⁴⁸

This system of financing was not to the taste of the government. A new regime was introduced under the Finance Act 1956: nationalised enterprises had no direct access to the UK financial market.¹⁴⁹ Future borrowings were to come from the Exchequer; initially from the Consolidated Fund and after 1968 by loans from the National Loans Fund.¹⁵⁰ Hence the industries had less financial independence under the new Acts than under the original nationalisation statutes. The importance of this point cannot be overstated: as Sir Christopher Foster writes

If there was one feature that distinguished post-war nationalization from pre-war public ownership, it was that government controlled all nationalized industry borrowing, on the ground that it necessarily guaranteed the borrowing - a dogma which was to be of the greatest importance both throughout the (post-war) period of nationalization and in bringing about privatization.¹⁵¹

In addition to the statutory control of borrowings, the government also introduced a new generation of "non-statutory financial targets"¹⁵²: ministerial control was soon extended to other aspects of finance, including (i) tariffs and (ii) major procurement contracts.

- Tariff control

Ministers exercised two kinds of non-statutory control in connection with tariffs:

(i) The minister might block price increases. As was mentioned above (Part II., Efficiency gains), the government placed various constraints upon price increases in

¹⁴⁴William A. Robson: *Nationalized Industry and Public Ownership* (1960), page 65.

¹⁴⁵R. Kelf-Cohen: *Twenty Years of Nationalisation* (1969), page 215.

¹⁴⁶R. Kelf-Cohen: *Op. cit.*, page 215.

¹⁴⁷With the exception of the coal industry which was always financed from government resources.

¹⁴⁸R. Kelf-Cohen: *Twenty Years of Nationalisation* (1969), page 197.

¹⁴⁹Michael G. Webb: *The Economics of Nationalised Industries* (1973), page 143.

¹⁵⁰Select Committee on Nationalised Industries: *Reports and Accounts HC 304 1957-8*, Appendix 1. and Cmnd. 7131 (1978), section 90.

¹⁵¹C.D. Foster: *Privatization, Public Ownership and the Regulation of Natural Monopoly* (1992), page 78.

¹⁵²Electricity Consumers' Council: *The Financing of the Electricity Supply Industry* (1984), Summary.

the 1970s.¹⁵³ After the passage of the Counter-Inflation Act 1973 the government, acting through the Price Commission, could veto tariff increases.

(ii) Sometimes it was the minister who fixed the level of tariffs. A report from the Monopolies and Mergers Commission revealed that the government gave 'guidance' to the electricity companies on pricing policy and also on specific tariffs.¹⁵⁴ For example, such guidance was used to introduce the so-called 'differential charge' in 1948.¹⁵⁵

There is little doubt that the British government preferred technique (i) to technique (ii). Actually, governments of all political colours seem to opt for the former method. The right to veto proposed price increases is a useful weapon to fight against inflation; and it also saves the minister from preparing detailed price calculations. For example, the Department of Water and Electric Energy may veto tariff increases in Brazil.¹⁵⁶ In Hungary, the government may veto price proposals prepared by the Energy Office.¹⁵⁷

Thus British Ministers, like their opposite numbers in Brazil or in Hungary, rather 'blocked' than 'fixed'.

- Procurement contracts

This issue will be illustrated here by reference to the South of Scotland Electricity Board - litigation.¹⁵⁸ The main points of the three cases quoted may be summarised as follows: the parties executed an agreement in 1962 which bound the electricity board not to take supply of coal from other sources than the coal corporation.¹⁵⁹ As far as the contractual obligation of British Coal was concerned, the agreement merely provided "that if the defenders ever sought a given tonnage, the pursuers [i.e. the coal corporation] would make that known tonnage available to them."¹⁶⁰ The lifetime of the said agreement was extended three times between 1970 and 1986.¹⁶¹ The coal corporation had a good reason to stick to the agreement: mines in the vicinity of the power stations had no other outlet.¹⁶² But what did the electricity board gain from

¹⁵³Richard Pryke: *The Nationalised Industries* (1981), page 38. In connection with government interference with pricing, see also: William A. Robson: *Nationalized Industry and Public Ownership* (1960), pages 290 - 297; William Ashworth: *The State in Business* (1991), pages 52 - 53.; R. Kelf-Cohen: *Nationalisation in Britain* (1961), page 219.

¹⁵⁴The Monopolies and Mergers Commission: *Central Electricity Generating Board HC 315 1980-1*, page 15., point 3.13.

¹⁵⁵Sir Norman Chester: *The Nationalisation of British Industry* (1975), pages 711 - 712.

¹⁵⁶Jose Riberio Pena Neto: *Overview of the Brazilian Electricity Sector*. Source:

<http://www.energyonline.com/Restructuring/models/brizill.html>

¹⁵⁷See Chapter 6., point 1.5.

¹⁵⁸**British Coal Corporation v. South of Scotland Electricity Board 1988 S.L.T. 446; 1991 S.L.T. 302; and 1993 S.L.T. 38.**

¹⁵⁹Background to the coal - electricity generation agreements is analysed in: *Electricity Consumers' Council: The Financing of the Electricity Supply Industry* (1984), pages 4-5., points 3.3. - 3.4.

¹⁶⁰**British Coal Corporation v. South of Scotland Electricity Board 1988 S.L.T. 446**, at 448-I.

¹⁶¹at 447 F-H.

¹⁶²at 447 -J-K.

granting exclusivity in favour of the coal corporation ? Hardly anything; the price of coal to be supplied was not fixed under the agreement.

Why did not the South of Scotland Electricity Board try to purchase coal from other sources ? Two points should be underlined here:

- (i) No alternative suppliers were available *in Britain* - interest in worked and unworked coal was vested in British Coal under the Coal Industry Nationalisation Act 1946.
- (ii) The Scottish company may not approach foreign coal suppliers: the minister instructed all the electricity boards *not to import* coal.

The main point from the South of Scotland Electricity Board - case is that the government had an active interest in coal purchase agreements: the Scottish company might not refuse to take coal from local mines, even though the British Coal offer was not competitive. The story of the South of Scotland Electricity Board was not a one-off example. The Electricity Consumers' Council noted in a report that there was "direct intervention in the CEEGB's coal purchasing policy."¹⁶³ A report from the Monopolies and Merger Commission also confirmed that the government had an active interest in procurement contracts. In connection with fuel purchase agreements the Commission reported to the Parliament that

... the CEEGB had agreed with the Department of Energy not to enter into coal import contracts without first consulting the Department, that the Secretary of State for Energy would decide if imports were necessary and whether they would be handled by the CEEGB or the NCB.¹⁶⁴

The CEEGB - example and the idea of arm's length control may not be reconciled. The point here is that ministerial control was stretched over and beyond the applicable statutory bounds. Ministers controlled not only the borrowings of nationalised enterprises, but also tariff policy and certain procurement contracts. For example, under the Electricity (Scotland) Act 1979 the minister had statutory authorisation neither to fix tariffs nor to block proposed tariff increases¹⁶⁵. Section 2 of the Coal Industry Act 1977 authorised the Secretary of State to make grants to the National Coal Boards "for the purpose of promoting the sale of coal" to the electricity generating boards. Yet the legislator did not envisage that the minister would

¹⁶³Electricity Consumers' Council: Coal and the Interest of Electricity Consumers (Privatisation Discussion Paper No. 3.) (1987), page 20., point 65.

¹⁶⁴The Monopolies and Mergers Commission: Central Electricity Generating Board HC 315 1980-1, page 161., point 7.15.

¹⁶⁵Schedule 4 (Gas Supply Code), Section 12 of the Gas Act 1972; Section 23 of the Electricity (Scotland) Act 1979. A historical comment: the minister had the right to block price increases under the Gas Charges Order of 1942. Source: Sir Norman Chester: The Nationalisation of British Industry (1975), page 710.

eventually decide whether the CEGB may import coal or not. How could the minister exercise powers not granted by Acts of Parliament ?

According to Professor Thornwill it was the right to issue general directions which "led to the growth of a secondary area of non-statutory intervention by Ministers". He argues that

It is not the case that Ministers have *abused* their statutory powers, but rather that the statutory powers have enabled Ministers to extend their influence beyond the area envisaged when the statutes were enacted.¹⁶⁶

The right to issue general directions undermined the idea of 'arm's length' control. Ministerial intervention under the shadow of general directions shifted nationalisation away from the Morrison concept in the UK. The outcome is well known: nationalised enterprises were declared to be inferior to private companies. Perhaps critics were too harsh: it was not nationalisation *generally* which failed in the UK. The story of the British nationalisation programme is the failure of a *particular* model of public corporations. It was argued above that (i) government controlled all nationalized industry borrowing, tariffs and procurement contracts *via* (ii) non-statutory intervention. Points (i) and (ii) brought down nationalised enterprises in Britain. This story is about the failure of a model which omitted a central element of Morrison's idea: enterprises were NOT run at arm's length control from the government. Who knows what would have happened had the Morrison-model been implemented in full.

(B) Informal procedures *versus* legalism

So far as post-privatisation regulation is concerned the main point from the above discussion is as follows: non-statutory intervention had a decisive influence upon the regulation of nationalised boards in Britain.

It was mentioned above that not many general directions were issued to the boards. Is it right to claim then that such directions re-arranged relations between the boards and the ministers ? If no directions were issued how could they possibly have any influence ?

One of the golden rules of British administration is that open confrontations between governors and governed should be avoided, if possible. Ministers and nationalised enterprises followed the same approach. As Sir Norman Chester noted,

... a situation in which a Minister and a Board appointed by him had to settle their differences by litigation seemed wholly inconsistent with the harmony of relationships necessary for the smooth working of the undertaking in the national interest.¹⁶⁷

¹⁶⁶W. Thornwill: *The Nationalised Industries. An Introduction* (1968), page 35. Italics retained.

¹⁶⁷Sir Norman Chester: *Op. cit.*, page 989.

As a main rule, disagreements were negotiated after nationalisation; ministers tried to 'persuade' chairmen and *vice versa*.¹⁶⁸ If this conciliation procedure failed, then the minister might issue a general direction addressed to the rebellious board. In practice, neither ministers nor boards found such directions particularly appealing.

- As to Boards:

The nationalised enterprises were powerless against the sponsoring departments. To avoid public humiliation, board members either (i) gave in to ministerial pressure before the direction would have been issued or (ii) resigned. As Professor Thornwill notes,

... the mere existence of the power to issue a direction rather than its actual issue will be enough to enable the Minister to get his way.¹⁶⁹

- As to Ministers:

Professor Prosser notes that ministers rather preferred not to issue directions. He points out that enterprises were obliged to publish ministerial directions in their annual reports.¹⁷⁰ This level of publicity had two, perhaps unintended, consequences: general directions (i) would have showed that "relations between minister and board had broken down"; and (ii) "would have given at least a clue to the degree of responsibility of government for particular actions of the boards."¹⁷¹ Hence the issuing of directions was the very last resort which was "to be used in exceptional circumstances".¹⁷²

Thus ministers and boards tried to avoid formal procedures; informal contact was the preferred regulatory technique.¹⁷³ The final point here is that ministers and nationalised utilities had a joint interest to avoid formal procedures. Informal methods of regulation, like confidential discussions, persuasion, made formal directions redundant. Thus regulation was "lying in the shadow of the law" in the era of nationalisation.¹⁷⁴

¹⁶⁸See Part I., A.1. above.

¹⁶⁹W. Thornwill: *The Nationalised Industries. An Introduction* (1968), page 37.

¹⁷⁰See, for example, Section 8(2) of the Gas Act 1972.

¹⁷¹Tony Prosser: *Nationalised Industries and Public Control* (1986), page 24.

¹⁷²Sir Norman Chester: *Op. cit.*, page 1036.

¹⁷³Tony Prosser: *Op. cit.*, page 24.

¹⁷⁴Martin Stewart-Smith: *Industry Structure and Regulation* (The World Bank, Policy Research Working Paper, No. 1419.) (1995), page 26.

3.2. The myth of independent regulators

John Moore, the then Financial Secretary to the Treasury, advertised privatisation as follows: "Privatisation decisively breaks the political link."¹⁷⁵ As far as price regulation is concerned, the government was particularly keen to keep this promise. "To avoid undue risk to shareholders", a total of nine single industry regulatory offices were established¹⁷⁶. In theory, the single industry regulators are independent of the government.

The discussion below will attempt to offer a non-official view of the British regulatory system. It will be argued that economic regulation is a game with at least two referees, i.e. the government (acting through the Secretary of State) and the regulator. Between the two of them the Secretary of State has more statutory power. In the light of that point the independence of the regulators may be questioned.

The Comptroller and Auditor General starts his analysis of the regulators' statutory powers with the following statement:

The government also have important continuing responsibilities for regulating the economic activities of companies in the four industries [i.e. telecommunications, gas supply, water services, and electricity supply].¹⁷⁷

What is the relationship between those 'continuing responsibilities' and statutory powers of the Directors General ? One would suppose that after privatisation the regulatory offices will exercise all regulatory powers save those which might not be assigned to a single industry regulator (for example, general competition policy). Yet the division of statutory powers follows different principles under the privatisation Acts. According to the findings of the Comptroller and Auditor General, the Secretary of State has a number of responsibilities.¹⁷⁸ For example, he may

- (i) grant or revoke licences;
- (ii) issue regulations relating to the services or supply;
- (iii) set or approve the standard of quality;
- (iv) regulate connection charges.¹⁷⁹

¹⁷⁵John Moore: Why Privatised? in: Privatisation and Regulation - the UK Experience (1986), page 89.

¹⁷⁶Centre for the Study of Regulated Industries & Price Waterhouse: Op. cit., page 14, point 2.4.1.

¹⁷⁷National Audit Office: The Work of the Directors General of Telecommunications, Gas Supply, Water Services, and Electricity Supply HC 645 1995-96, page 7, point 2.8.

¹⁷⁸In the case of the gas industry, more than 40 functions are listed on three pages. See: HC 645 1995-96, pages 201-204, point B.9.1.

¹⁷⁹See replies from the Directors General to question B.9. In: HC 645 1995-96.

If the above mentioned functions are reserved for the Secretary of State, what is the regulator supposed to do ? On the face of it, there is no shortage of statutory powers allocated to the Directors General. Principal functions include, among others,

- (i) fixing maximum prices;
- (ii) making references to the Monopolies and Mergers Commission;
- (iii) determining certain types of disputes;
- (iv) advising the Secretary of State on regulatory matters.¹⁸⁰

Before one would rush to conclude that the Directors General have no less responsibilities than the Secretary of State, three additional points should be considered:

(i) Power Constrained

As a rule, a Director General may not exercise all the above listed powers as and when (s)he thinks fit to do so. One of the regulators, Professor Littlechild, noted that the power of the Director(s) General "derives from or is constrained by the Secretary of State."¹⁸¹ This point will be demonstrated by reference to the 'modification of licences' procedure.¹⁸²

Section 11 of the Electricity Act 1989 provides that "... the Director may modify the conditions of a licence if the holder of the licence consents to the modifications". Modification by agreement is an original jurisdiction of the Director; the Secretary of State has no power to amend licences.¹⁸³ Yet the Secretary of State must receive a notice about the proposed modification. Under Section 11(4) of the Electricity Act 1989, the Secretary of State may direct the Director not to make any modifications, and "the Director shall comply with the direction". The Secretary of State may exercise similar powers under Sections 12(5) (Modification references to Monopolies Commission) and 13(6) (Reports on modification reference). As Phillips LJ remarked in **Regina v. Director General of Telecommunications, ex parte British Telecommunication plc. (QBD)**, LEXIS, 20 December 1996, decisions of the Directors General concerning the modification of licences are "subject always to the overriding power of veto of the Secretary of State."

Another technique to curtail the power of regulators is to grant jurisdiction over the same matter to (i) the Secretary of State and to (ii) the Directors General. For example, either the Secretary of State or the Director General of OFGAS may notify the Public Gas Transporter that a gas supplier is not entitled to make a 'special

¹⁸⁰See replies from the Directors General to question B.3. In: HC 645 1995-96.

¹⁸¹S.C. Littlechild: Office of Electricity Regulation: The New Regulatory Framework for Electricity in: Cento Veljanovski (ed): Regulators and the Market (1991), page 116.

¹⁸²References are made to the Electricity Act 1989; the same points also apply in the case of the Gas Act 1986, the Water Industry Act 1991, and the Telecommunications Act 1984.

¹⁸³Cosmo Graham and Tony Prosser: Privatizing Public Enterprises (1991), page 191.

customer payment' claim.¹⁸⁴ The licence does not say what shall happen should the two officers disagree; perhaps it goes without saying that the Secretary of State's opinion will prevail.

Constraints on power creates both personal and professional dilemmas. Sir Bryan Carsberg, the former telecommunications regulator, complained in the press about the frustration he felt "in the shadow of the Secretary of State".¹⁸⁵ In the gas industry Ms. Clare Spottiswoode appears to pursue a pro-competition policy. Yet in a letter addressed to the Editor of The Financial Times she lamented that she cannot actually widen competition; "... such a move would require a statutory instrument by the Secretary of State for Trade and Industry".¹⁸⁶

(ii) Regulators ignored

The legislator did not have a blueprint for the division of responsibilities between the Secretary of State and the Directors General. Privatisation Acts and secondary legislation entrusted important regulatory functions to the Secretary of State. Three examples will suffice here:

(a) Licensing

As a rule, it is the competent Secretary of State (and NOT the regulator) who may issue licences in the telecommunication, electricity, gas and water sectors.¹⁸⁷ For example, Section 6(1) of the Water Industry Act reads as follows:

Subject to the following provisions of this Chapter, a company may be appointed

- (a) by the Secretary of State; or
- (b) *with the consent of or in accordance with a general authorisation given by the Secretary of State*¹⁸⁸, by the Director

to be the water undertaker or sewerage undertaker for any area of England and Wales.

Thus Colin Scott correctly notes that "the right to grant authorizations and to set conditions is held by the Secretary of State".¹⁸⁹ Licences are the omega

¹⁸⁴Section 10(3)(b) of the Standard Conditions of Public Gas Transporters' Licences (1996).

¹⁸⁵The Financial Times, 29 November 1994.

¹⁸⁶The Financial Times, 12 July 1994.

¹⁸⁷Tony Prosser: Law and the Regulators (1997), pages 97, 127, and 152.

¹⁸⁸Italics added.

¹⁸⁹Colin Scott: Privatization, Control, and Accountability In: Joseph McCahery, Sol Picciotto and Colin Scott (eds): Corporate Control and Accountability (1993), page 243.

and alpha of utility regulation; it is not clear then why ministers (as opposed to regulators) were in charge of drafting the first generation of licences. Legislators in other countries do not follow the British example: for example, the Gas Act 1994 of Hungary provided that the Energy Office (and NOT the Minister) shall draft the country's first utility licences.¹⁹⁰

(b) Approval of Code of Practice

The Water Industry Act 1991 provides that rules concerning (a) general environmental and recreational duties and (b) environmental duties with respect to sites of special interests may be promulgated in Codes of Practice. Pursuant to Section 5(1) of the said Act it is the Secretary of State (and not the Director General of OFWAT) who may approve such Codes. He should consult a number of bodies (e.g. the Environmental Agency, the Historic Buildings and Monuments Commission) before making an order under Section 5. But, and this is the point here, the Secretary of State is under no duty to consult the Director General of OFWAT. Hence it would appear that the legislator has forgotten about the regulator on this occasion.

(c) Liberalisation

The detailed discussion on liberalisation is reserved for Chapter 2.; the point here is that the introduction of competition was a 'managed process' in Britain.¹⁹¹ And who managed this process? One would suppose that the Directors General are "as well, or better, placed than anyone in this country"¹⁹² to decide when and how competition should be phased in. But the British legislator disagreed: the Competition and Services (Utilities) Act 1992 empowered the Secretary of State to reduce monopoly thresholds in the **gas** and **water** sectors. Clare Spottiswoode referred to this point in her letter quoted above.

As far as the **telecommunication** sector is concerned, Tony Prosser points out that "Government has had a key role in determining the amount of competition".¹⁹³ For example, the government (as opposed to the Director General of Telecommunications) lifted the ban on the number of telecommunication licences in 1991.¹⁹⁴

The **electric** industry is the exception here: it is the Director General of OFFER who has control over the liberalisation of the domestic electricity market. Why is the electric industry different from telecommunication, gas and

¹⁹⁰For more details, see Chapter 6. below.

¹⁹¹Centre for the Study of Regulated Industries and Price Waterhouse: *Regulated Industries: The UK Framework* (1996), page 18.

¹⁹²Sir Ralph Gibson in: *R. v. Director General of Electricity Supply, ex parte Scottish Power* (1997), LEXIS, 3 February 1997.

¹⁹³Tony Prosser, *op. cit.*, page 60.

¹⁹⁴Competition and Choice: Telecommunications Policy for the 1990s, Cm. 1461 (1991).

water ? The introduction of competition did not require legislative action here; it was within the powers of the Director General of OFFER to reduce the so-called 'franchise limits' in the licences. Had a statute been required, one may not rule out that the Parliament would have empowered the Secretary of State to oversee the liberalisation of the domestic electricity market.

To conclude, the Parliament empowered the Secretary of State to manage the introduction of competition in the telecommunication, gas and water sectors. The Directors General of OFTEL, OFGAS and OFWAT would have been better placed to carry out this job. Yet the legislator did not trust the regulators. Hence the liberalisation of utility services remained a political (as opposed to regulatory) issue in the UK.

(iii) General Directions

The Secretary of State may also give so-called 'general directions' to the Directors General.

The question here is whether the existence of 'general directions' is a possible threat to the independence of regulators. Perhaps not and this is for the following reasons:

- Privatisation statutes provide that 'general directions' shall indicate "considerations to which the Director should have particular regard".¹⁹⁵ But there is no statutory requirement that the regulators must comply with such directions. The situation would be different if the Secretary of State were entitled to issue 'instructions': Sir Thomas Bingham noted in **R. v. Director of Passenger Rail Franchising, ex parte Save Our Railways and Others (CA)**, LEXIS, 15 December 1996 that recipients MUST comply with 'instructions'. That is not the case so far as 'general directions' issued under the privatisation Acts are concerned: the regulator may disagree with the Secretary of State.
- General directions fit uneasily with general regulatory procedures. It was mentioned above, that utility regulation is informal (as opposed to legalistic) for the time being. If the Secretary of State wants a Director General to consider certain factors, (s)he will not issue 'general directions'. It is more likely that the regulator will be invited for an informal meeting or for a lunch.

To conclude, compared with the era of nationalisation, 'general directions' are less important today: such directions (i) do not bind the regulators and (ii) fit uneasily with the general pattern of post-privatisation regulation.

This is not to say, however, that 'general directions' may be disregarded in analysing the relationship between ministers and regulators. The idea that the Secretary of State may 'draw' the attention of the regulator to certain factors is reminiscent of

¹⁹⁵See, for example, Section 34(3)(a) of the Gas Act 1986.

nationalisation (see: point 3.1(ii) above). If the intention was to break 'the political link'¹⁹⁶, the legislator should have deleted 'general directions' from the statute book.

What points should be summarised here ?

The following words were quoted from Mrs. Beckett, the President of the Board of Trade in the Preface: the government "need to ensure that the balance between Ministers and regulators is correct."¹⁹⁷ The above discussion has tried to argue that the balance is certainly NOT correct for the time being. It is the Secretary of State who holds the ultimate power in regulation. Thus the government may wield political influence over regulation after privatisation; just as it actually did during the second phase of nationalisation. It is an open question today whether the proposed review of utility regulation will help the new government to find the 'correct' balance between ministers and regulators.

Conclusion

The COLLINS COBUILD dictionary refers to 'nationalisation - denationalisation' to show that the prefix 'de-' changes the meaning of a verb to its opposite. This Chapter has tried to argue that denationalisation may not be a perfect example. The discussion above has tried to show that privatisation may be seen as the continuity of nationalisation. Two points support that argument:

- Nationalisation and privatisation have the same, or very similar, regulatory principles: price regulation is not set forth under the relevant Acts of Parliament; utilities are generally obliged to supply consumers; and consumer protection is an issue of secondary importance. Amendments in technical details (like, timing of price review is agreed in advance; certain costs may be passed through) benefit privatised utilities and not their consumers.
- Ministers have retained important powers after privatisation: the licensing of suppliers, the liberalisation of the UK gas, telecommunication and water sectors are examples. Relations between ministers and regulated utilities will be informal; negotiation is the name of the regulatory game. Law seems to be kept to the sidelines.

Hence the editors of COLLINS COBUILD may have to look for a better example than *nationalize - denationalize* to demonstrate that the prefix 'de-' changes the meaning of a verb to its opposite.

¹⁹⁶John Moore used this expression in his paper " Why Privatise ?" Privatisation and Regulation - the UK Experience (1986), page 86.

¹⁹⁷House of Commons: Hansard, 30 June 1997, Column 21.

Chapter 2.

Government and Privatised Utilities - Interference and Competition

In an ideal world the present chapter would be very short or, perhaps, missing altogether. In an ideal world government interference would be exceptional: the form and likely direction of such interference would be predictable. Should that be the case, would a thesis about the UK privatisation policy devote a separate chapter to this issue?

This is not an ideal world: the British government does interfere with the operation of privatised utilities. The main point from Chapter 1. is that politicians are the chief 'referees' in the regulatory game. The Secretary of State is the most influential decision maker; Directors General of the regulatory offices are not truly independent regulators. Interference *via* utility regulation is not the full story: government interference may take a variety of forms. Informal telephone calls, letters addressed to the CEO of a privatised utility, the power to appoint directors or other officers, the right to approve certain corporate actions (winding up, disposal of certain assets etc.) are examples.

The examples listed above may be divided into two groups: (a) Informal channels (telephone calls, letters, and the like) and (b) Legal instruments (all the other examples). The scope of this Chapter is limited to group (b): Informal channels will NOT be discussed below. Furthermore, it should be noted that this Chapter will not cover all legal instruments: *Residual government stakes* will be discussed first. Part II. will deal with (i) the legal standing of '*Golden Shares*' in Britain and (ii) the reception of Golden Shares in Central Europe. Issues concerning the status of *government-appointed directors* will be analysed in Part III. Finally, the *introduction of competition* in the telecommunication, electricity, gas and water industries will be analysed in Part IV. This Chapter will not discuss, for example, *limits on foreign shareholdings*. The reasons for this may be summarised as follows:

- **Ineffective** - If foreign investors are really determined to acquire control, "limitation on shareholdings" - rules will not bar them from purchasing shares. The Hungarian gas sector is an example. As will be discussed in Chapter 6., Russian gas companies could not bid for Hungarian gas distribution companies at privatisation: in addition, there are "limitation on shareholdings" - rules in place in the post-privatisation phase. The intention was to keep Russian gas companies out from the provision of energy services in Hungary. Yet two years after privatisation Gasprom, the Russian gas giant, ran two out of five companies. Hence "limitation on shareholdings" - rules may not work in practice.
- **Embarrassment** - Further problems will follow if "limitation on shareholdings" - rules are enforced. A company may find it particularly embarrassing "to require

some foreign holders to sell because the limit had been breached.”¹ For example, British Aerospace plc. and Rolls Royce plc. reported that “. . . some of those investors who suffered have never renewed their interest.”² Hence “limitation on shareholdings” - rules may put off both potential and existing investors.

- **EU law** - The legality of “limitation on shareholdings” - rules is subject to some debate within the EU. The trouble here is that limitation on shareholdings “. . . leaves investors from European Union nations on the same footing as other overseas institutions.”³ According to the European Commission, this arrangement is discriminatory and illegal: limits “must be scrapped for all members of the European Union”⁴. Unfortunately, many EU countries take no notice of what the Commission is saying: France, Germany, and the UK did introduce “limitation on shareholdings” rules. There is another point here: it is ironic that certain EU states refer to the same EU rules when urging Central and Eastern countries to remove restrictions on foreign investment. It is unclear why EU candidates should comply with certain rules existing members are welcome to disregard.

To conclude, governments may be advised NOT to introduce “limitation on shareholdings” - rules: (i) limits may not protect privatised companies from foreign take-overs; (ii) it is embarrassing to enforce such limits; and (iii) limits on foreign shareholdings are illegal under EU law. Why did the British, German, French, Hungarian etc. governments opt for such limits? The only possible reason is politics: this thesis tries to steer clear of political arguments. Hence it may be a good idea not to discuss the issue of “limitation on foreign shareholdings” further here.

Part I.

Residual Government Stakes

The starting point here is that the British government did not intend to retain residual shares in privatised companies. As a financial journalist put it, residual government shares “smack of a paternalistic Toryism which is clearly an anathema to free-marketeers”.⁵ The political intention was to sell the entire share capital of privatisation candidates, if possible. This policy was by no means restricted to privatisation candidates operating in the market sector. The government decided not to retain residual stakes in a number of public utilities (e.g. British Gas plc, the Scottish electricity companies) and in companies of strategic importance (e.g. British Airports Authority).

It should be noted, however, that the government held residual stakes in the following companies:

¹The Sunday Times, Section 3., page 1., 5 January 1997.

²The Sunday Times, op. cit.

³The Sunday Times, op. cit.

⁴The Sunday Times, op. cit.

⁵The Financial Times, November 2 1989.

Name of company privatised	Date of first privatisation	Percentage of residual stake
British Aerospace plc.	February 1981	48.4 percent
Cable & Wireless plc.	October 1981	50.6 percent
Britoil plc.	November 1982	49 percent
Ass. British Ports plc.	February 1983	48.5 percent
British Telecommunication plc.	November 1984	49.8 percent
Nat.Power/PowerGen plc.	March 1991	40 percent

TABLE 4. Residual shares in Britain

Out of the six projects listed above five took place between 1981 and 1984, while the electricity generators were sold in 1991. Thus the first phase of the British privatisation programme was the golden age of residual stakes in Britain. By 1995 all of the above listed stakes were sold off, while no government holdings were retained in the case of subsequent privatisation projects.⁶ Hence residual stakes are a piece of privatisation history in Britain. Yet government-owned shares play an important role in Europe. As a main rule, European utilities are sold off in two or more rounds: governments tend to retain majority holdings in privatised companies. Two issues should be considered here: (i) What are the main reasons for retaining shares after privatisation ? and (ii) Why did the British government get rid of its shareholdings ?

2.1. Reasons for holding residual stakes

The three most likely reasons for retaining residual stakes are as follows:

- (1) Size of privatisation candidate;
- (2) Timing of other flotations; and
- (3) Desire to retain some control.

Points (1) - (3) will be discussed in turn below.

As to (1).

The unusual size of British Telecommunication plc. was a decisive factor in structuring the telecommunication disposal of 1984.⁷ The total value of the government's shareholding in BT was approximately GBP4 billion. The capacity of the British financial market for all new equities was estimated to be in the region of

⁶Privatisation International, January 1997, page 21.

⁷The size of telecommunication giants usually has a decisive influence on the structuring of sales. See, for example, the privatisation of Deutsche Telecommunication; or the sale of the Saudi telephone company - the Financial Times, May 8 1998.

GBP2 billion per annum.⁸ Hence at least two business years would have been needed to purchase up all BT shares. The financial community in London was doubtful about the capacity of the capital markets to absorb such a huge offering.⁹ The fixed price offer of 50.2% of British Telecommunication in November 1984 was meant to reflect the capacity of the London financial market for new securities.¹⁰

As to (2)

The sale of National Power plc. and PowerGen plc. was scheduled for early 1991. It was a period after the flotation of the twelve regional electricity companies (1990) but before the proposed sale of Scottish Power plc. and Scottish Hydro-Electric plc. (1991). The government sold all its shareholdings in the electricity companies and was hoping to offer 100% of the two Scottish companies. Due to practical limitations on the size of the market for electricity shares, the total disposal of National Power plc. and PowerGen plc. was out of the question. The decision to offer 60% of each company was reached with a view to avoiding the early saturation of the market.

As to (3)

Points (1) and (2) do not apply in the case of British Aerospace plc., Cable & Wireless plc., Britoil plc. and Associated British Ports plc.: these companies were not 'too' big (unlike BT) and the timing of flotation was not problematic (unlike in the case of the Scottish electricity companies). Why then did the government opt for partial privatisation of these companies? In addition to points (1) and (2) mentioned above, there is a third argument for creating government shares: it is the intention to retain some control after privatisation. For example, Stephen Dow argued for the retention of residual stakes as follows: he claimed in a study that the government should have retained a shareholding in the electricity sector so as to have some influence over the running of electricity companies in the transitional period [i.e. between privatisation (1990/1991) and full liberalisation (1998)].¹¹

Russian privatisation law is another example here. According to Emilia A. Simonelli and M. Sidney Donica, the Russian government must sell residual shares within three years from the date of the initial disposal. But this mandatory sale - rule would not apply (i) if the company privatised is "extremely profitable" or (ii) if the government

⁸ John Moore: British Privatisation - Taking Capitalism to the People In: H.M. Treasury: Guide to the UK Privatisation Programme (1993), page 70.

⁹ Ibid, page 60. And also Committee of Public Accounts: Sale of Government Shareholding in British Telecommunication plc. HC 35 1985-6, page xi.

¹⁰ In the case of Indonesia, 388m shares were sold in December 1996. According to the government, the size of the sale was determined by the size of the market. See: The Financial Times, 12 December 1996.

¹¹ Stephen R. Dow: A Survey of Major Developments in the Post-privatisation phase of UK Gas and Electricity Supply Industries (1996), pages 59 - 60.

intends to retain control over the company.¹² The first rule is self-explanatory; it is exception (ii) which should be considered in some detail. This point and Stephen Dow's argument seem to raise the same question:

Does the creation of residual stakes guarantee that the government will 'have some influence over the running of privatised companies'?

Before trying to answer this question it should be noted that, compared with Britain, the 'desire to have some control' point is more relevant in Europe. As a rule, the appetite for post-privatisation control techniques seems to be bigger on the Continent than in the UK. That would not be a problem itself, but the introduction of different forms of government interference has not been co-ordinated. As will be argued below, two or sometimes three control mechanisms co-exist in Europe. In Italy, the government retained a 52.75% stake in INA, an insurance company, after the first round of privatisation.¹³ Partial privatisation seems to be the preferred technique in France. The government shareholding in Renault was reduced from around 80% to 50% in November 1994. Yet the government refused to comment on full privatisation of the French car maker.¹⁴ The latest privatisation plan from France is again a partial disposal: an "about 20 %" stake in France Telecom is due to be offered for sale.¹⁵ In Poland the Ministry of Privatisation intended to sell a minority stake in Fampa, a manufacturer of papermaking machinery, "for fear that the sale of majority control to a foreign investor would be politically unpalatable."¹⁶ In the Czech Republic, foreign investors were invited to acquire a 15.15% stake in Stavby Silnic a Zeleznic (ZSSZ), a construction enterprise, in June 1992.¹⁷ Hence European governments have a number of residual stakes: do they have 'some influence over the running of' privatised companies?

Consider the example of MATÁV Rt., the Hungarian telecommunication company. The government approved the sale of MATÁV in 1993 *on condition* that the state shall retain a majority stake after privatisation.¹⁸ Thus investors were invited to acquire "a significant minority stake"¹⁹. Potential bidders indicated that they would be happy with a minority stake *provided* that they could acquire certain management

¹² Emilia A. Simonelli and M. Sidney Donica: A Guide to Investing in the C.I.S. In: Journal of the Newly Independent States of the Former Soviet Union Law Committee, Volume 2., Issue 1., Summer/Fall 1997, pages 16 - 64., at 31.

¹³ The Financial Times, 28 and 29 November 1994.

¹⁴ The Financial Times, 29 November 1994.

¹⁵ The Financial Times, 11 November 1996. and also The Financial Times, 31 December 1996/1 January 1997.

¹⁶ Susan L. Rutledge, Martin C. Stewart-Smith, Christina Kappaz, Maziar Minovi: Selling State Companies to Strategic Investors (1995), page 4.

¹⁷ Ibid, pages 78. - 79.

¹⁸ The disposal of a minority stake in national telecommunication companies appears to be a trend all over the world. For example, an 11 % stake was sold in Singapore Telecommunication in October 1993 (The Financial Times 23 May 1994.); a 25 % in OTE in Greece (The Financial Times 14 November 1994.)

¹⁹ Anna Canning: Privatisation and Competition in Hungarian Telecommunications (Discussion Paper in Economics, No. 69/9.) (1996), page 11.

rights under the shareholders' agreement. While details of the agreement are confidential, it is understood that the successful bidder, a German - American consortium, has the right to appoint (i) the chief executive officer and (ii) the director of finance. To conclude, the Hungarian state retained a majority stake in MATÁV Rt., nevertheless it is the minority shareholder who run the company.

The main point of the MATÁV story is that residual stakes do not matter: the fact that residual stakes have been retained does not necessarily imply that the government will be able to influence the running of privatised companies. The question is who controls the board after privatisation: and it is not always the majority shareholder. The Hungarian telecommunication company is an example. Thus Stephen Dow's recommendation mentioned above should be treated with caution: the retention of residual stakes may NOT guarantee that the government will 'have some influence over the running of privatised companies.

2.2 Problems with residual stakes

As a rule, governments could be notoriously difficult business partners. Nationalised enterprises in Britain were well aware of the fact that ministerial decisions did not always follow commercial principles. Investors feared that government shares will be voted to foster political goals. In connection with the primary offer of British Telecommunication shares, a senior official from the Treasury summarised the main concerns of potential investors as follows:

If we had instead offered it [i.e. BT shares] in a number of tranches buyers would have been uncertain about the way the Government might use the majority of shares that would have remained in its hands.²⁰

Hence the dilemma for the Tory government was how to dispel doubts concerning the voting of residual stakes.

Investors might have expected guarantees under the general principles of Company law in vain. The starting point here is that H.M. Government was one of the millions of shareholders after the sale of the first tranche of shares in British Aerospace plc., Cable & Wireless plc., and the like. Traditional company law view holds that a shareholder is free (i) to vote her/his shares in any manner she/he pleases and (ii) to transfer her/his shares to whosoever she/he pleases.²¹ In other words, shareholders are "entitled to sell their shares, to vote their shares, to take any course they like in general meeting without regard to any other person's right or position."²² Thus the

²⁰Committee of Public Accounts: Sale of Government Shareholding in British Telecommunication plc. HC 35, 1985-6 page 3.

²¹For a recent discussion of the issue see the speech of MacDermiott LJ in **Russel v. Northern Bank Development Corporation Ltd. and others** [1992] BCLC 431.

²²Harman J. in **Re Unisoft Group Ltd. (No. 3.)** [1994] 1 BCLC 609, at 622.

government was under no company law duty to consider the interest of private shareholders.

Investors would have been better protected under American company law. According to Professor Gower, the US judiciary recognised as early as the 1950s that some restrictions shall be placed on shareholders' freedom "to exercise their proprietary rights in any way they like". The idea that "controllers owe fiduciary duties to the minority" is a well-established principle in US company law.²³ While the existence of fiduciary duties had some influence in British academic circles²⁴, the idea of 'fiduciary duties' owed to fellow shareholders is almost unknown in the UK. **Clemens v. Clemens Bros Ltd. and another** [1976] 2 All ER 268. and **Estmanco Ltd. v. Greater London Council (Vac. Ct)** [1982] 1 W.L.R. 2 are examples.

(a) Clemens - case

Foster J. ruled in this case that a shareholder was not entitled to exercise her majority votes in any way she pleased. Her right was declared to be subject to equitable considerations which might make it unjust to vote her shares in a particular way.

The individual circumstance of Clemens were unique: the Ms. Clemens was a majority shareholder and also a director of the company. This case is not a terribly good reference; it may be easily distinguished. Hence the practical importance of Clemens is limited.

(b) Estmanco - case

Sir Robert Meggry V.-C. found that the majority may have to consider the circumstances of minority shareholders in certain cases. He noted that

Plainly there must be some limit to the power of the majority to pass resolutions which they believe to be in the best interests of the company and yet remain immune from interference by the courts.²⁵

Yet Clemens and Estmanco are more the exception than the rule: as was noted above, the majority of British judges may not acknowledge that 'controllers owe fiduciary duties to the minority'. To conclude then, shareholders do not owe a fiduciary duty to fellow shareholders under British company law.

²³Gower's Principles of Modern Company Law (1992), page 605., footnote 67.

²⁴See, for example, Maw on Corporate Governance (1994), page 8.

²⁵At 11-H.

Thus fiduciary duties did not dispel uncertainties about the voting of residual stakes. Hence the government offered two alternative guarantees: (i) Target Investment Limit and (ii) Statements of intention. Both of them will be examined in turn below.

(a) Target Investment Limit

Five privatisation statutes²⁶ empowered the Secretary of State to designate the upper limit for government shareholding. The limit was to be set as a proportion of the voting rights exercisable at general meetings. The main rule was that once the initial limit is set, any new limit must be lower than the one it replaces. The Secretary of State fixed target investment limits by order.²⁷

As on so many other occasions in the history of privatisation²⁸, Target Investment Limits were introduced on an *ad hoc* basis. The logical approach would have been to set Target Investment Limits (i) in every partially privatised company (ii) at a level not less than 25.01%, i.e. investors may not pass extraordinary resolutions without the consent of the government. Yet this is not what happened in Britain. Out of the seven companies listed above (see: Table 4.), the legislator did not provide for investment limits in the case of (i) Cable & Wireless plc., (ii) Britoil plc., and (iii) Associated British Ports plc. On the other hand, Target Investment Limits were set for companies which were fully privatised.²⁹ Furthermore, Target Investment Limits were fixed at a senselessly low level: the government was entitled to retain stakes between 1.32% and 2.13% in the case of the English and Welsh electricity distribution companies.³⁰ So far as corporate governance is concerned, such a small stake may be ignored.

(b) Statements of intention

The Secretary of State issued two statements of intention in connection with the future of residual stakes. As a rule, the statements of intention were set forth in a letter addressed to the Chairman of the company to be privatised. The said letter was published in the relevant sale prospectus, usually under the heading "Relationship with HM Government". The wording of the two statements of intention slightly varied from company to company; the most widely used statements were drafted as follows:

²⁶British Aerospace Act 1980, Telecommunications Act 1984, Gas Act 1986, Electricity Act 1989, and Coal Industry Act 1994.

²⁷See, for example, Section 54(1) of the Gas Act 1986.

²⁸See, for example, the retention of residual government shares above, or the introduction of Golden Shares below.

²⁹British Gas plc. (Section 54 of the Gas Act 1986), English and Welsh electricity distribution companies (Section 74 of the Electricity Act 1989).

³⁰SI 1991/1199.

Statement I.

HM Government does not intend to use its rights as an ordinary shareholder to intervene in the commercial decisions of [name of company]. It does not expect to vote its shareholding on resolutions moved at General Meetings, although it retains the power to do so.³¹

Statement II.

It [HM Government] will not sell or otherwise dispose of any of its holding (except under arrangements for the share bonus) before [date]³². . . . Before any such sales or disposals and the arrangements therefor are made, HM government will take into account the views of the Directors of the Company.³³

Why did the government issue these statements ? The number one rule of privatisation is that investors want to get control. They do not mind how many shares the government intends to retain PROVIDED that the residual stake will not 'disturb' the running of privatised companies. The disposal of MATÁV, the Hungarian telecommunication company (see above), is an example: the German - American consortium was happy with a **minority** stake: they acquired **full** management control. If residual government stakes are retained, investors will not bid for shares unless they are protected against two 'disturbances': the government would (i) use its shares to intervene in commercial decisions of the company; and (ii) sell its shares to a third party. The two statements quoted above were issued to assuage fears by investors (and their advisors): 'disturbances' (i) and (ii) will not occur.

The UK government took the statements of intention seriously: the Secretary of State was reluctant to use her/his rights as an ordinary shareholder. But the voting of the residual shares would have been in the best interest of the privatised company on certain occasions. The story of British Aerospace plc. is a good example here.

Thorn - EMI initiated merger talks with British Aerospace plc. in May 1984. H.M. Government held 48.43% of the issued share capital.³⁴ The government tried to make its position clear the following day. The Secretary of State announced that he would not interfere; it was up to the other shareholders to make up their minds.³⁵ The neutral stance adopted by the government was in accordance with the statements

³¹ Actual wording from British Telecommunication: Offer for Sale of Ordinary Shares (1984), page 6.

³² The practical importance of setting a target date was emphasised before the Committee of Public Accounts in connection with the primary offer of BT shares. See: Committee of Public Accounts: Sale of Government Shareholding in British Telecommunication plc. HC 1985-86 35, page 3.

³³ Actual wording from British Telecommunication: Offer for Sale of Ordinary Shares (1984), page 6.

Section 7(5) of the Industry Act 1972 contained a similar provision.

³⁴ The Financial Times, 16 May 1984.

³⁵ The Financial Times, 17 May 1984.

published in the British Aerospace prospectus³⁶; but this attitude created a state of limbo. After five weeks of hesitation the company rejected the Thorn - EMI offer. A new predator emerged in June 1985: GEC from the USA started merger talks with British Aerospace plc. The government emphasized that it would support whatever decision the company might take. Perhaps a better solution would have been to make a declaration what the government actually thought about the GEC - BAe merger. Had the government supported the GEC offer, then the takeover would have been completed promptly; had the government voted its shares against the merger, the predator would have had no choice but to back off.

The point here is then that statements of intention created an 'unnatural situation' in Britain: the statements precluded the government from voting its residual shares. This policy was not in line with ordinary business practice. As Keith Stuart Esq., the chairman of Associated British Ports said,

It is an unnatural situation to have a major shareholder which cannot exercise any control.³⁷

Why would the holder of a 48.43% stake refrain from voting its shares at company meetings ? Or why should the government pledge not to vote in opposition to a resolution supported by a majority of directors³⁸ when it was known in advance that the board will be dominated by private shareholders ? It is not clear how this arrangement was supposed to protect the British public. It would have been quite right for the government to take an active interest in the management of *partially* privatised companies. Yet the two statements of intention analysed above barred the government from voting its residual stake. Although the government was a major shareholder after the primary offers, full management control slipped into the hands of private investors. The new shareholders paid for around **50%** of the shares but acquired **full** control over partially privatised companies. This is one of the reasons why the secondary offers were not really successful: investors may not wish to acquire additional shares when they are already in control.³⁹ The best example here is Britoil plc: the share price was 215p/share in 1982, while the remaining 49% was sold for 185p/share three years later.⁴⁰ The Hungarian state did not do much better from the sale of the national telecommunication company. The first 30.2% stake of MATÁV

³⁶The Financial Times, February 5 1981. and also Committee of Public Accounts: Sale of shares in British Aerospace HC 189, 1981-2, page viii.

³⁷The Financial Times, 11 April 1984.

³⁸Associated British Ports Holding plc.: Offer for Sale of Ordinary Shares (1983), page 18.

³⁹For a brief analysis about the financial results of the British secondary offers see: The Financial Times, 25 February 1985.

⁴⁰Her Majesty's Treasury: Guide to the UK Privatisation Programme (1993), page 11., point 51. See:

was sold for USD 875m in 1993, but the second tranche of 37% fetched USD 852m only.⁴¹

To summarise, residual government shares did not quite work in Britain. Private investors held slightly more than 50% of the issued share capital but had full control over privatised companies. Associated British Ports plc. and British Aerospace plc. are examples. Unfortunately, foreign governments did not learn from British privatisation experience: residual stakes have been in Central and Eastern Europe. The disposal of MATÁV, the Hungarian telecommunication company, is an example. The final point here is that the state was the long-term loser from partial privatisation projects both in the UK and in Hungary: (i) the government held residual shares but could not really control partially privatised companies; and (ii) investors paid less for residual stakes than for shares sold in the primary offers.

It is no surprise then that the Treasury announced in 1984 that the government intended to sell its minority holdings in several quoted companies.⁴² This policy was implemented without delay: the government sold its residual stakes in Associated British Ports plc. (1984), British Aerospace plc. (1985), and Britoil plc. (1985). According to *The Economist*, the UK government held equity shares in thirty three private sector companies in 1992, out of which only three stakes (British Telecommunication plc., National Power plc., PowerGen plc.) were of significant size.⁴³ These holdings were privatised in 1993 and in 1995 respectively. No residual shares were retained in the latest projects (Rail Track plc., British Energy plc.). According to Privatisation International, H.M. Government holds shares in British Telecommunication plc. and in Mersey Docks & Harbour Co. at present.⁴⁴ Thus residual stakes disappeared in Britain.

Part II.

Golden Shares

As was mentioned above, the British government tried to sell existing stakes from 1984 and did not retain significant residual holdings in newly privatised companies. The decline of residual stakes coincided with the introduction of a new post-privatisation control mechanism, the so-called Golden Share. It became the preferred form of government interference: there were some forty Golden Shares by 1993.⁴⁵ The discussion below will attempt to analyse the legal nature of Golden Shares. Golden Shares are very simple in principle: instead of holding huge chunks of shares after privatisation, the state should retain one special share per company only. Rights

⁴¹ Anna Canning: *Privatisation and Competition in Hungarian Telecommunications* (Discussion Paper in Economics, No. 69/9.), pages 11. and 14.

⁴² *The Financial Times*, 15 March 1984.

⁴³ *The Economist*, 11 July 1992.

⁴⁴ Privatisation International, January 1997, page 21.

⁴⁵ H.M. Treasury: *Guide to the UK Privatisation Programme* (December 1993), Appendix F.

attached to this single share are so defined as to enable the government to intervene "in appropriate cases to safeguard the national interest".⁴⁶

The first Golden Share scheme was set up in Amersham International Ltd. in 1982; more Golden Shares followed soon.⁴⁷ Yet Golden Shares were introduced on an *ad hoc* basis in Britain. For example, no Golden Share was retained in the main port operator (Associated British Ports plc.); but Sealink Ltd., one of the carriers, was privatised with a Golden Share⁴⁸. Exactly the opposite arrangements are in place in the air traffic sector: the operator of leading airports (British Airports Authority plc.) has a Golden Share, but not the main carrier, British Airways plc.

This thesis does not intend to discuss why or why not politicians introduced Golden Shares; the main question here is how the legal nature of Golden Shares may be defined.

2.3 Legal nature of Golden Shares under British law

The most important characteristics of Golden Shares are that (a) the holder of this share may exercise (b) special rights under (c) certain circumstances. To understand the legal nature of Golden Shares points (a) - (c) should be analysed in turn.

Point (a) - The holder of the Golden Share

As a rule, the Golden Share may only be held by the Secretary of State, or another Minister of the Crown, the Treasury Solicitor or "any other person acting on behalf of the Crown".⁴⁹

The personality of the holder of the Golden Share is of paramount importance. It is up to the competent Secretary of State whether a Golden Share will be voted or not. Takeovers of privatised companies are the best examples here. The Secretary of State for Trade and Industry was willing to waive the Golden Share in Jaguar so as to let Ford to take over the British car manufacturer.⁵⁰ Some six years later a new Secretary of State pointed to the Golden Share in National Power to fight off a potential bidder.⁵¹

To conclude, Golden Shares will always be controlled by a Government agent, usually by the relevant Secretary of State. The Golden Share will be activated as and when those influential enough within the government think fit to do so.

⁴⁶The Financial Times, 15 March 1984.

⁴⁷For example, British Telecommunication plc, VSEL Consortium, British Gas plc., Rolls-Royce plc., British Airports Authority plc., British Steel plc., the ten English and Welsh water companies, and each company in the British electricity sector.

⁴⁸HC 34 1985-6, pages ix - x.

⁴⁹British Energy: International Offer and UK Public Offer Prospectus (1996), page 128.

⁵⁰Cosmo Graham and Tony Prosser: *op. cit.*, pages 148 - 149.

⁵¹See, Chapter 5., Part I., C., (3) below.

Point (b) - Special rights

Compared with ordinary securities, Golden Shares carry certain extra rights. Before discussing what those rights are, it would be useful to make an introductory point here.

As Professor Gower notes, "the initial presumption of the law is that all shares confer the same rights and impose the same liabilities."⁵² This presumption might be modified by the creation of different classes of shares. As a rule, different classes may carry different rights as to (i) dividends, (ii) return of capital on winding up, and (iii) attendance and voting at company meeting.⁵³ Traditional business practice held that preferential treatment as to one of these rights should be granted with the corresponding reduction in the entitlement to other shareholders' rights. For example, preference shares paid a fixed dividend "before any dividend is paid on the company's ordinary shares".⁵⁴ But these shares had no votes unless such dividends were in arrears. Deferred shares carried 'disproportionally large voting rights'⁵⁵ but limited right to dividends. Thus extra-rights (e.g. fixed dividend in the case of preference shares) counterbalance rights taken away (preference shares - no votes): this is the 'balancing theory'. The diagrammatic presentation of this theory would be as follows:

	Preference share	Deferred Share
Right to vote	NONE	Extra
Right to dividend	Extra	NONE

TABLE: 5.: Balancing theory in the case of Preference and Deferred Shares

Golden Shares seem to challenge the validity of the 'balancing theory'. As a rule, Golden Shares confer no right (i) to vote nor any other rights at any company meeting nor (ii) to participate in the capital or profits of the company "except that, on a distribution of capital in winding-up, the holder of Special [Golden] Share is entitled to repayment of GBP1 [i.e. the nominal value of the Golden Share] in priority to other shareholders."⁵⁶ Thus both (i) the right to dividend and (ii) the right to vote have been taken away: is it to say that the 'balancing theory' may not be applied to Golden Shares? Two issues should be considered before answering that question:

1./ Extra voting rights

The statement that Golden Share carries no right to vote should be qualified here: the **first generation** of Golden Shares did have extra voting rights. Hence the first

⁵²Gower's Principles of Modern Company Law (1992), page 361.

⁵³Ibid, page 369.

⁵⁴Robert R. Pennington: Company Law (1990), page 206.

⁵⁵Ibid, page 219.

⁵⁶Actual wording from: British Energy: International Offer and UK Public Offer Prospectus (1996), page 128.

generation of Golden Shares was hardly more than a developed version of deferred shares mentioned above: in certain circumstances the holder of the Golden Share had disproportionately large voting rights, but no right to dividend. This arrangement was introduced in the case of Britoil plc. and Enterprise Oil plc. The relevant provisions of the Articles of Association may be summarised as follows:

If the holder of the Golden Share had reasonable grounds for believing that a "relevant person" has obtained or is attempting to obtain control over the board, (s)he was required to give a written notice to the board. After the delivery of such notice the holder of the Golden Share

- might call an extraordinary general meeting; and
- at the EGM the Golden Share carried a total number of votes which was

... one more than the total number of votes which may be cast on such poll in respect of all the voting shares which are not registered in the name of the Secretary of State [i.e. the holder of the Golden Share].⁵⁷

Similar arrangements applied if a "relevant person" attempted to acquire more than 50 per cent of the voting rights. But the holder of the Golden Share need not give notice to the board here: the threat of 'unwelcome' take-over automatically triggered the special voting rights of the Golden Share.

The first generation of Golden Shares was a "relatively unsophisticated device".⁵⁸ The British Petrol - Britoil takeover - saga is an example here. As was mentioned above, the holder of the Golden Share (i) had the right to call an extraordinary general meeting if Britoil was the target of a takeover bid; and (ii) could outvote private shareholders at the EGM. Thus the holder of the Golden Share had the right, among others, to appoint directors to the board of Britoil. The designers of the Golden Share thought that the company would not be an attractive target if the predator could not obtain control over the board. While this argument is correct in principle, it did not quite discourage British Petrol from making a hostile bid for Britoil. Thus the first generation of Golden Shares did not work well in practice; the Golden Share did not deter potential predators from making 'unwelcome' bids. This is why the **second generation** of Golden Shares was introduced in Britain.

John Moore, the former Financial Secretary to the Treasury, summarised the key characteristics of the second generation of Golden Shares as follows:

They are always tied to one or more specific provisions in a company's articles of association; they do not carry voting rights; they do not give

⁵⁷ Britoil: Offer for Sale of Ordinary Shares (1982). Re-printed in The Financial Times, 12 November 1982.

⁵⁸ Cosmo Graham and Tony Prosser: Privatizing Public Enterprises (1991), page 142.



the government control over a company's activities except in the specified area; and they confer no right to interfere in management decisions. But they are an effective way to resolve concern about the national interest.⁵⁹

The ingenuity of the second generation of Golden Shares is that it has nothing to do with 'turbo' voting rights.⁶⁰ The Golden Share constitutes a special **class of shares**; the Articles of Association lists certain matters (to be discussed under heading (c) below) which are deemed to be proposed variation of the class rights attaching to the Golden Share. The Articles of Association provides that such variations are effective only with the consent in writing of the holder of the Golden Share. The beauty of the classic model is that Golden Shares do not outvote private shareholders. This type of Golden Shares offers a more discreet form of protection: "... certain provisions in the Articles of Association . . . may not be changed without the specific consent of the special shareholder."⁶¹ Thus the second generation of Golden Shares may stop things before they actually happen: certain actions are impossible unless approved by the holder of the Golden Share in advance. Are extra-rights and rights taken away balanced in the case of the second generation of Golden Shares ?

2./ Repayment in priority to other shareholders

The first comment here is that the repayment of GBP1 is hardly worth mentioning in the light of emoluments paid to directors of privatised utilities. Nonetheless, the provision that the holder of the Golden Share shall be repaid in priority to other shareholders is a standard term in the Articles of Association of all privatised utilities. Why was the repayment provision considered to be so important ? Its practical implications, if any, are limited: the omission of this point would have made no material difference. The right to be repaid in priority to other shareholders does not make sense unless one were to accept the 'balancing theory'. The special provision as to repayment intends to counterbalance the taking away of other shareholder rights, namely the right to vote and the right to dividends.

To conclude then both the first and the second generations of Golden Shares are 'balanced': the right to dividend has been taken away, but extra rights (first generation - right to vote; second generation - right to repayment) have been granted to the holder of the Golden Share. Thus the balancing theory of shareholders' right is applicable to Golden Shares.

⁵⁹ John Moore: British Privatisation - Taking Capitalism to the People In: H.M. Treasury: Guide to the UK Privatisation Programme (1993), page 67.

⁶⁰ Gower's Company Law seems to advocate a different view. Professor Gower writes that the Golden Share enables the government "to outvote all others on certain types of resolution". While this statement is true in the case of the first generation of Golden Shares, the second generation does not carry voting rights. See: Gower's Principles of Modern Company Law (1992), page 77.

⁶¹ H.M. Treasury: Guide to the UK Privatisation Programme (1993), page 7.

Point (c) - Circumstances

Proposed variations of rights requiring the consent of the holder of the Golden Share fall into two groups. The first group includes matters designed to protect the special status of the Golden Share. Without the consent of the holder of the Golden Share (i) provisions in the Articles of Association relating to the Golden Share may not be amended, removed or altered; (ii) no voting shares may be created or issued with the exception of shares carrying ordinary voting rights; and (iii) voting rights may not be varied.

The second group is concerned with (i) strategic issues, like limitation on shareholding⁶², nationality of directors⁶³ and (ii) actual management decisions, like the appointment of certain company officials⁶⁴, the voluntary winding up of the company, and the disposal of material parts of assets⁶⁵. There is an unusual provision in the Articles of Association of Scottish Nuclear plc.: the transfer out of Scotland of any of its headquarters' functions is deemed to be a proposed variation of the rights attached to the Golden Share.⁶⁶

To conclude the above discussion, the legal nature of the second generation of Golden Shares may be summarised as follows:

- The Golden Share constitutes a separate class of shares carrying no right to vote or to dividend;
- Rights attaching to the Golden Share may only be altered with the consent in writing of the holder of this share; and
- Certain matters listed in the Articles of Association are deemed to be a proposed variation of the class rights mentioned above.

So far as company law is concerned, these three points are truly important; they determine the legal nature of Golden Shares in Britain. The next question is how these points have been transplanted into foreign legal systems.

⁶²As a general rule, no person is allowed to acquire an interest of more than 15% of the total votes. See: introduction to this Chapter.

⁶³For example, Rolls-Royce plc., British Energy plc.

⁶⁴Directors in the case of British Telecommunication plc (British Telecommunication: Offer for Sale of Ordinary Shares (1984), page 47.), the Chairman of the board in the case of British Energy plc. (British Energy: International Offer and UK Public Offer Prospectus (1996), page 128.).

⁶⁵The disposal of material assets is not deemed to be a variation of class rights in every Golden Share scheme. This provision may be found in the case of, for example, Amersham International plc. (subsequently redeemed), British Telecommunication plc., Rolls-Royce plc., and British Energy plc.

⁶⁶British Energy: International Offer and UK Public Offer Prospectus (1996), page 129.

2.4. Reception of Golden Shares in Hungary

Professor Alan Watson writes in connection with the reception of Roman Law that

... ruler or legislature accepting Roman law as a whole or as glossed as subsidiary law clearly has no precise interest in the political, social, or economic messages of the individual rules.⁶⁷

The reception of Golden Shares in Europe shows that the validity of this statement is by no means restricted to Roman law. A number of European countries adopted Golden Share-like arrangements over the last decade; but the political message of the British rules did not come through in every country. The discussion below will be concerned with the reception of Golden Shares in Hungary.

The privatisation of the Hungarian telecommunication, gas and electricity companies was depended upon, among others, the introduction of Golden Share-like schemes. For example, the first tender for the privatisation of the regional gas distribution companies was called off in 1992. The government told potential investors that post-privatisation control techniques should be in place before gas companies would be offered for sale. The privatisation agency was instructed to introduce Golden Shares.⁶⁸ Was the reception of Golden Shares a sound project in Hungary?

It was certainly not impossible: the reception of the second generation of Golden Shares did not require any amendment to the Hungarian Companies Act 1988. It should be recalled that the conclusion above listed three simple points about the legal nature of Golden Shares in Britain. Thus Golden Shares may be introduced in any legal system which recognises the following company law principles:

- (1) The share capital of a company may be divided into different classes of shares.
- (2) Different classes might carry different rights as to (i) dividends and/or (ii) votes.
- (3) Rights attached to a particular class of shares might not be altered without the consent of the holders of that class of shares.

The above listed conditions are incorporated in Sections 234., 242., and 283. respectively of the Hungarian Companies Act 1988. Thus the Hungarian legal system was ready for the reception of the second generation of Golden Shares. The drafting of Articles of Associations was also in safe hands: the London-offices of well-known international law firms advised the Hungarian privatisation agency.⁶⁹

⁶⁷ Alan Watson: *Failures of the Legal Imagination* (1988), page 136.

⁶⁸ For more details, see Chapter 6., point 2.4.

⁶⁹ For example, Clifford Chance in connection with the privatisation of the Hungarian gas distribution companies.

Why was the reception of Golden Shares delayed then ? There are no legal solutions for political unwillingness. Ministries, public utilities, and trade unions lobbied against the introduction of Golden Shares in Hungary. It is beyond the scope of this thesis to analyse all relevant articles, public addresses, or lectures. Two extreme examples will suffice here:

(i) A senior civil servant stated in a confidential ministerial document that the Golden Share is a share certificate the edges of which are gold-plated. He concluded that no such security should be introduced in Hungary.

(ii) The former head of the legal department of the privatisation agency published a lengthy article in a Hungarian daily paper.⁷⁰ He argued that Golden Shares may only be introduced upon registration with the Companies Court. The hidden message of the article was that public utilities should be wound up and re-registered with Golden Shares: this exercise would have taken roughly two - three years to complete.

Fiscal considerations smashed opposition to Golden Shares in Hungary. The 1994 - 95 budget provided for HUF 150bn (cc. GBP468m) proceeds from the sale of state-owned companies. Without the disposal of public utilities this plan was illusory. Hence the minister responsible for privatisation ordered the acceleration of all major privatisation projects. As one of the preparatory steps, the Articles of Association of Hungarian public utilities were amended: Golden Shares were introduced.

But Hungary did not opt for the second generation of Golden Shares. Decision makers did not learn from British experience: the Hungarian privatisation agency acted on the understanding that 'turbo' voting rights are indispensable to Golden Shares. Thus Golden Shares in Hungary appear to be similar to the Britoil - Enterprise Oil solution. For example, in the case of MATÁV the holder of the Golden Share is entitled to 50,000,000,000 votes in certain circumstances.⁷¹

The main point here is that Hungary adopted that version of Golden Shares in 1995 which had been discarded in Britain in the late 1980s. It is a mystery why Hungary chose an outdated model; as was noted above, the reception of the second generation of Golden Shares would have been viable at no extra cost. The above quoted section from Professor Watson offers a possible explanation: the Hungarian legislator did not consider the political, social, or economic messages of the British rules on, and experiences with, the second generation of Golden Shares.

⁷⁰ Népszabadság, 5 April 1995. The article also appeared on the Internet: <http://www.nepszabadsag.hu>.

⁷¹ Articles of Association of MATÁV Rt., as amended in December 1993.

Part III.

Government-Appointed Directors

It was noted in Part I. that the government may not control privatised companies through residual stakes unless boards are packed with government nominees. How many of them were actually appointed ? Seven government-appointed directors served on the boards of four privatised companies before 1984.⁷² Another two were appointed to the board of British Telecommunication plc.⁷³ Although Cento Veljanovski claims that a government nominee joined the board of British Gas plc.⁷⁴, the prospectus does not mention that the government had the right to appoint a director.⁷⁵ According to the Treasury, none of them holds office as of today.⁷⁶ Yet government-appointed directors have not disappeared on the Continent: as a rule, no utility privatisation project is completed without the appointment of new 'nominee' directors. Dissimilarities between the Continental and British experience raise the question: Why did government-appointed directors fail in the UK ? It will be argued below that they provided important services: government-appointed directors constituted a communication channel between the government and privatised companies. Why did not they stay on then ? The second part of the discussion will attempt to answer that question. It will be argued that the legal foundation of this institute was fragile under British law: government-appointed directors could not do what they were supposed to do. The main comparative point is that government-appointed directors operate in a different legal environment in other European countries; they are likely to face a more buoyant future there.

2.5 Role of Government-appointed Directors

The first question here is what government-appointed directors were expected to do. Different departments held different views as to the responsibilities of government-appointed directors. The Committee of Public Accounts published a special report about the role and duties of government directors.⁷⁷ As far as the role of directors is concerned, the Report offered two versions:

⁷²British Petroleum plc. (two government appointed directors); Britoil plc. (two); Cable & Wireless plc. (one); and British Aerospace plc. (two). Source: Committee of Public Accounts: Role and Responsibilities of Nominee Directors HC 33 1985-6 (incorporating HC 124-i 1984-5), Annex A.

⁷³British Telecommunication: Offer for sale of Ordinary Shares (1984), page 48. and The Financial Times, 21 September 1984.

⁷⁴Cento Veljanovski: *Selling the State* (1987), page 127.

⁷⁵British Gas: Offer for Sale (1986). Published in: The Financial Times, 25 November 1986.

⁷⁶Telephone conversation with Privatisation Unit of HM Treasury on 9 November 1996.

⁷⁷Committee of Public Accounts: Role and Responsibilities of Nominee Directors HC 33, 1985-6, incorporating HC 124-i, 1984-5,

(a) Official Version

According to the official version, government-appointed directors were supposed to help government departments. The Treasury told the Committee of Public Accounts that government-appointed directors were

- to safeguard strategic interests;
- to protect the Government's financial interest in a company; and
- to provide an independent view of the quality and performance of the company's Board.⁷⁸

Representatives of the Treasury also told the Committee that "... the main reason for appointing nominee directors to companies was to aid the development of those companies, ...".⁷⁹ Thus the Treasury assigned two roles to government-appointed directors: they were expected (i) to assist departments and (ii) to aid companies. As a matter of fact, these two objectives might not always run in the same direction. It will be examined below what government-appointed directors could do if the two roles conflicted.

The main point here is that the official version from the Treasury set forth contradictory expectations. Government-appointed directors were to serve two masters (i) the Treasury and (ii) the company at the same time.

(b) Non-official Version

Development agencies presented additional reasons for the appointment of nominee directors. For example, the Welsh Development Agency told the Committee that its nominee directors were required to send copies of minutes and agenda of board meetings to the Agency. The Scottish Development Agency reported that its nominee directors were expected to inform the Agency of matters of material importance. Representatives of the Agency met the directors on a regular basis. The Highlands and Islands Development Board followed similar practices.⁸⁰ In short, nominee directors passed on confidential information and internal documents to the appointing agency. Did the same function exist in the case of directors appointed by the government? The Committee noted that government-appointed directors were expected "to inform the Government of the companies' trading performance and strategy, thus supplementing contacts with Board chairmen."⁸¹ The Treasury emphasised in the Annex to the Memorandum submitted to the Committee that government-appointed directors

⁷⁸ HC 33, 1985-6, incorporating HC 124-i, 1984-5, page vi.

⁷⁹ Ibid, page vi.

⁸⁰ Ibid, page xi.

⁸¹ Ibid, page xi.

should seek to ensure that the Government is informed of any significant developments of interest to it as Government whether as shareholder, lender or guarantor or more generally.⁸²

A Permanent Secretary met government-appointed directors on a regular basis to discuss business matters. The Committee referred to these meetings as "confidential discussions with directors"⁸³.

The legal problem here lies in the passing on confidential information to the government. Two issues should be considered here:

(i) Access to information

The Committee of Public Accounts did not investigate what information government-appointed directors actually passed on to the appointing bodies. It is not clear whether government-appointed directors were aware of all 'significant developments'. As a rule, board members may be cut off from information in Britain. It is a standard practice today that committees (as opposed to full board) make strategic decisions. Members of Committee X do not have a statutory right to inspect minutes of proceedings of Committee Y.⁸⁴ It may not be ruled out that government-appointed directors happened to be members of 'less important' committees (e.g. Public Relations Committee), while other committees made strategic decisions. The government did not stipulate in the Articles of Association that government nominees must have full access to documents: hence it is questionable whether government-appointed directors were aware of all major developments within privatised companies.

Draftsmen of the Fifth Company Law Directive did address this potential problem. Article 11 (5) of the draft Directive provides that each member of the supervisory organ or each non-executive director (in the case of two-tier management structure) are entitled to "examine all reports, documents and information" supplied. Thus had the Fifth Company Law Directive been in force, government-appointed directors could not have been cut off from information.

(ii) Disclosure of business information

It is trite law that directors must not disclose confidential or sensitive information to third parties. This obligation lingers on after the termination of appointment.⁸⁵ The same rules were applicable to both government- and agency-appointed directors; hence confidentiality should have been a potential source of concern.

⁸²Ibid, Annex C.

⁸³Ibid, page xi.

⁸⁴*M'Cusher v. M'Rae* 1966 SC 253 and D.D. Prentice: A Director's Right of Access to Corporate Books of Account (1978) 94 LQR 184.

⁸⁵Gower's Principles of Modern Company Law (1992), page 553.

The regional development agencies address this issue as follows. The duty of confidentiality was waived in a contract between the investee company and the agency. Financial assistance to investee companies was granted *on condition* that the nominee directors were authorised to pass on confidential information to the appointing bodies.⁸⁶

It is regretted that no similar arrangements were made in the case of government-appointed directors: government appointees were not exempted from ordinary fiduciary duties. They were responsible and liable like any other directors.⁸⁷ Two issues follow from this point:

- Breach of confidentiality

As was noted above, government-appointed directors were a communication channel between the government and privatised companies: they were expected to inform the appointing departments about 'any significant developments'. Strictly speaking, government-appointed directors were in breach of their fiduciary duties if and when they passed on confidential information to the government. Unlike agency appointed directors, government nominees were not exempted from the duty of confidentiality.

- Fiduciary duties *versus* interests of the government

It was not always easy to reconcile (a) fiduciary duties owed to the privatised company and (b) Treasury interests. Two simple examples may be mentioned here:

- (a) The board intends to bring legal action against H. M. Government. The chairman of the board and the CEO believe that it would be in the best interest of the company to sue the government. The board is split into six against six; it is the government-appointed director's turn to cast her/his vote. How shall (s)he vote ?
- (b) The board of a privatised company intends to take the company's banking business to Switzerland. The board believes that it would be in the best interest of the company to use Swiss banks in the future. Shall a government-appointed director inform the Treasury about this proposal ?

The law may be summarised briefly: the Privy Council ruled in **Kuwait Asia Bank EC. v National Mutual Life Nominees Ltd. [1991] 1 AC 187**, that nominee directors are bound to ignore the interests and wishes of the appointing body. Lord Lowry underlined that nominee directors "... could not plead any instruction from the bank [i.e. the appointing body] as an excuse for breach of their fiduciary duties ...".

⁸⁶HC 33, 1985-6, incorporating HC 124-i, 1984-5, page xi.

⁸⁷Ibid, page vi.

H.M. Treasury came to the same conclusion in a House of Commons paper. The Treasury argued that

Government Directors have the same general responsibilities under the common law and under the Companies Act (whether those of Great Britain or Northern Ireland) to the Company for the control and management of its business as other directors, and must exercise their best judgement in the interest of the company. They are *not* the Government's delegates on the Boards on which they serve; their duties as director are owed to the company and not to the Government and if a nominated director were ever to be in breach of these duties it would not be an answer that his motives were public spirited and justified in terms of some wider public or national interest as defined by the Government.⁸⁸

The main point from the Kuwait Asia Bank - case and from the Treasury document is the same: government-appointed directors should ignore the interest and wishes of the appointing body. There is a paradox here: government directors are encouraged to disregard the interests of the government. What solutions are available ?

2.6. Potential Solutions

Professor Gower makes the following comment in connection with fiduciary duties:

It is often stated that directors are trustees and that the nature of their duties can be explained on this basis.⁸⁹

If fiduciary duties arise from the fact that directors are taken as trustees⁹⁰, the conflict between duties and wishes would not arise if the 'trustee' analogy were abandoned. Or, alternatively, the duties of 'trustees' could be modified in the case of nominee directors. Professor Gower seems to support the latter option; however experiences from abroad suggest that a lot may be said for the former.

Gower solution

Professor Gower argues that directors appointed by a particular class "shall pay special attention to the interests of that class whether that be of members or creditors."⁹¹ He refers to the Ghana Companies Code 1973 (Act 179) which reads as follows:

⁸⁸Ibid, Annex C.

⁸⁹Gower's Principles of Modern Company Law (1992), page 550.

⁹⁰Mayson, French & Ryan on Company Law (1996-97 edition), page 461., point 16.3.1.

⁹¹Gower's op. cit., page 556.

In considering whether a particular transaction or course of action is in the best interests of the company as a whole, a director, when appointed by, or as a representative of, a class of members, employers or creditors, may give special, but not exclusive, consideration to the interests of that class.⁹²

The draft EU Fifth Company Law Directive recommended a similar solution. Article 21q(2) of the draft Directive provided that

All the members of the administrative organ shall carry out their functions in the interest of the company,⁹³ having regard to the interest of the shareholders and the employees.

The 'special interest' approach seems to be unsatisfactory: this solution merely restates reality. Presumably it was never a secret that government-appointed directors did give special consideration to the interests of the government. The Gover solution does not explain how the duties *versus* interests controversy should be resolved.

Two alternative solutions would present themselves on the Continent.

Two-tier solution

Government-appointed directors may be placed in a supervisory board - style body. Supervisory board members are not involved in day-to-day management, their main duty is to monitor the development of the company. The advantage of this option is that (i) the trustee concept would remain intact in the case of executive directors, but (ii) government-appointed directors would be discharged from some of the "legal constraints" within which nominee directors operate.⁹⁴

There is a lot to be said for the introduction of a two-tier board system. As far as government directors are concerned, the main argument is that membership on supervisory boards would be an excellent post for senior civil servants. Delegates from ministries and, more recently from regulatory bodies, may harness working relations between the company and the competent ministry: they also report back to the government on financial circumstances of the company.

The idea of two-tier board was incorporated in the draft Fifth Company Law Directive. The Commission argued for the introduction of supervisory boards as follows:

The coexistence of people with totally different responsibilities in a single administrative body is no longer consonant with the requirements of modern management.⁹⁵

⁹² Ibid, page 556.

⁹³ OJ No. C 240, 9.9.1983, page 2.

⁹⁴ HC 33 1985-6, incorporating HC 124-i, 1984-5,, page xviii.

⁹⁵ Commission of the European Communities: EEC Fifth Company Law Directive (1973), page 43.

Article 3(1) of the draft Directive provided that EU-based companies above a certain size shall be managed by a management organ under the supervision of a supervisory organ. Yet British opposition to this Directive left little hope for the early introduction of supervisory boards: British companies will have no two-tier management system in the foreseeable future. Hence this proposal is likely to remain a theoretical option.

No vote solution

France offers another solution. Under the French Privatisation Act of 1993 the holder of the Golden Share has the right to appoint one or two representatives to the boards of companies to be privatised. These government-appointed directors attend board meetings, take part in the proceedings, but have no voting rights.⁹⁶ The French solution seems to offer the best of both worlds: (i) government-appointed directors are members of the boards and can influence the decision making process; but (ii) having no voting rights, they are not liable for board resolutions passed.

The UK did not follow the French lead. As a rule, government nominees could vote in Britain. For example, the Articles of Association of British Telecommunication plc. contained the following provision:

... In the absence of some other material interest, the Government-appointed Directors may vote in respect of any resolution concerning any matter in which the Crown may be interested or to or in which a Government-appointed Director may be a party or be interested on behalf of the Crown.⁹⁷

Yet voting rights had a mixed record in Britain. As a rule, government-appointed directors could not have intervened at board level successfully: they were in minority on the boards of privatised companies. There were only two government directors on the fourteen-member board of British Telecommunication plc.⁹⁸ Hence government-appointed directors could not outvote non-government members of the board.

Actually, government-appointed directors may exert influence over privatised companies even though they have no voting right. For example, nine government-appointed directors served on the board of San Miguel, a beer-based conglomerate, in the Philippines. When a bitter boardroom battle erupted between 'ordinary' and government-appointed directors in 1988 the latter refused to sign San Miguel's annual report.⁹⁹ Thus government-appointed directors could delay the approval of the annual report without using their voting rights.¹⁰⁰

⁹⁶Meredith M. Brown and Giles Ridley (eds): *Privatisation: Current Issues* (1994), page 114.

⁹⁷British Telecommunication: *Offer for Sale of Ordinary Shares* (1984), page 48.

⁹⁸*Ibid.*, page 22.

⁹⁹*The Financial Times*, 11 May 1988.

¹⁰⁰It is questionable whether this solution would work in Europe. There is no statutory requirement in Britain that all directors shall sign a company's annual report.

To conclude, government nominees may have some control over the running of privatised companies even though they have no right to vote.

Three potential solutions have been outlined above. Under the Gower - solution fiduciary duties would remain but would be modified in the light of "special, but not exclusive" considerations. The second solution advocated the introduction of a two-tier management system. The last solution is the reception of the French model. Government-appointed directors would have no voting rights, but would influence the decision making of the board indirectly.

Further options may be listed, of course. But it is quite unnecessary to search for potential solutions so far as the UK is concerned: government-appointed directors disappeared in Britain. The Articles of Association of privatisation candidates provided that the government had the right to appoint directors provided that H.M. Government held a certain percentage of voting rights. For example, the government had the right to appoint two non-executive directors to the board of Britoil plc. "so long as H.M. Government holds more than 35% of the voting shares of the Company."¹⁰¹ As was mentioned in Part I., residual government holdings were privatised. After the sale of British Petroleum, Britoil, Cable & Wireless, British Aerospace and British Telecommunication etc. stakes the government could not satisfy the condition mentioned above. Hence the government lost the right to appoint directors to the boards of privatised companies in Britain.

But contrary developments take place on the Continent: government-appointed directors serve on the boards of privatised companies. According to a study from the United Nations, Turkey and Portugal are especially keen to delegate "State-appointed directors".¹⁰² As will be discussed in Chapter 6., the Hungarian government-appointed a director to the supervisory board of each privatised utility company.

It is easy to see why this institute is flourishing in Europe. The two tier company management system is ideal for government-appointed directors: being members of the supervisory board they monitor the performance of privatised companies, but do not make executive decisions.

The final point here is then that, compared with Britain, government-appointed directors work in a more favourable legal environment on the Continent. Subjected to British company law doctrines (i.e. (i) fiduciary duties owed to company; (ii) no two-tier management system) government directors could not operate successfully. As Colin Scott argues, the inactivity of government-appointed directors

¹⁰¹ Britoil plc: The Financial Times, 12 November 1982.

¹⁰² United Nations: Comparative Experiences with Privatization (1995), page 116.

... combined with their duty to act in the best interest of the company, rather than of a particular shareholder, has meant that this device has had little perceptible impact.¹⁰³

Yet this form of government interference has a brighter future in Europe: government-appointed directors will stay on the board of privatised utilities.

Part IV.

A Time to Compete

While denationalisation and nationalisation have many regulatory principles in common (see Chapter 1. above), they hold diametrically opposing views about competition. To put it bluntly, nationalisation did not believe in competition, while the post-privatisation era is the age of liberalisation in Britain. The discussion below will explain this point in some detail.

Although it may sound absurd today, the designers of nationalisation blamed competition for the poor performance of public utilities. As David Coombes writes, "it was strongly believed that in most respects competition was harmful in the industries nationalized."¹⁰⁴ For example, a reader of *The Economist* argued in 1947 that the "greatest wastage of private industry arises from separate undertakings having to compete with each other"; and concluded that both gas and electricity must be "on the national balance sheet".¹⁰⁵ Few would agree with this statement today. But it should be recalled how the electricity and gas sectors looked like when the sentences quoted above were drafted. There were 505 electricity undertakings¹⁰⁶ and, as was noted in Chapter 1., over 100 electricity tariffs were charged. According to *The Economist*, the distribution side of electricity "was a patchwork which in some parts of the country looks like a crazy quilt."¹⁰⁷ Gas was even a 'crazier quilt': 269 local authorities, five joint boards, 509 independent companies and 264 undertakings under holding company control operated.¹⁰⁸ Some gas companies supplied a handful of customers only, while the biggest, Gas Light and Coke Company, controlled over 10% of the UK market. Both industries were earmarked for re-organisation in the 1930s. As *The Economist* reported,

In the decade before the war there were several sets of proposals, of varying degrees of authority, for the grouping of "authorised undertakers", and the debate went on during the war.¹⁰⁹

¹⁰³ Colin Scott: Privatization, Control, and Accountability In: Joseph McCahery, Sol Picciotto and Colin Scott (Editors): Corporate Control and Accountability (1993), page 241.

¹⁰⁴ David Coombes: State Enterprise (PEP, 1971), page 20.

¹⁰⁵ Letters to the Editor, 11 January 1947, page 61.

¹⁰⁶ National Power and PowerGen: Offers for Sale (1991), page 19.

¹⁰⁷ The Economist, 18 January 1947, page 93.

¹⁰⁸ The Economist, 8 December 1945, page 836.

¹⁰⁹ The Economist, op. cit.

Thus the reform of the gas and electricity sectors had been on the agenda before the war broke out: war-damage was not the principal reason for reorganisation in the electric and gas industries. But proposals were not implemented before or during the war and the structure of these industries remained unchanged. Hence hundreds of electricity and gas suppliers operated in the post-war era. Both the Labour and the Tory parties accepted that some 'co-ordination of the fuel and power industries'¹¹⁰ was desirable.

It remains a theoretical question how the Tories would have interpreted the term 'co-ordination'; the Labour party won the elections in 1945. The incoming government believed that 'co-ordination' meant the creation of monopolies. The theoretical case for the 'monopolisation' of utilities was set forth in the writings of a prominent party member, Mr. Herbert Morrison. It is well known that Mr. Morrison argued as early as 1933 that independent **public corporations** (point A.) must be the **monopoly suppliers** (point B.) of public services.¹¹¹ It is less well known, however, that the Labour party did not actually agree with both points. It was argued in Chapter 1. that point A. did not reach the statute book: **public corporations** were not run at arm's length from the government and their financial independence was notional. As David Coombes remarked in 1971,

The distinction recommended by Herbert Morrison between 'general policy' and 'day-to-day administration' has never been maintained in practice.¹¹²

It was point B. of the Morrison-model, i.e. **monopoly suppliers**, which the British legislator quite liked. It is well known that the 1945-1950 Labour government "sought to take whole industries into public ownership and to set up some form of centralized organization."¹¹³ Coal, gas, electricity supply, railways and steel were 'monopolised'. The following two points should be considered to appreciate why the Labour government wanted to create monopolies:

(i) Monopoly is beautiful

Mr. K. E. Boulding published an article in the August 1945 edition of *The Quarterly Journal of Economics* under the title 'In Defense of Monopoly'. He argued that there is an economic justification for monopoly: monopoly is a method to guard a business enterprise against the destructive effects of deflation.¹¹⁴ The idea that monopoly may be established to rescue an industry from decay had many supporters in Britain. For example, the Heyworth

¹¹⁰The Economist, 25 October 1947, page 696.

¹¹¹Herbert Morrison: Socialisation and Public Transport (1933).

¹¹²David Coombes: State Enterprise (1971), page 87.

¹¹³Ibid, page 21.

¹¹⁴The Quarterly Journal of Economics, Volume LX, November 1945, pages 612 - 621.

Committee reported in 1945 that the existing structure of the gas industry was likely to restrict further progress. The Committee advocated the compulsory acquisition of gas undertakings by the state arguing that

no voluntary process (of integration) is likely to be sufficiently speedy to satisfy present and future requirements.¹¹⁵

According to Sir Christopher Foster, the owners or operators of electric undertakings also wanted to "achieve greater economies of scale" *via* amalgamation.¹¹⁶ Politicians agreed: *The Economist* commented in connection with the Electricity Bill 1947 that

... the case for larger units of production and distribution and a greater centralisation of control and technical management is widely agreed.¹¹⁷

The Bill's central theme was "generally accepted by all parties."¹¹⁸ Thus economists and politicians found themselves in happy tandem in the mid-1940s: national or regional monopolies must be introduced in the electric and gas industries.

(ii) Monopoly and ministerial control

The Labour government had a practical reason for the 'monopolisation' of the electric and gas industries. As was mentioned above, the Labour party was not enthusiastic about the idea of 'arm's length' relationship between 'sponsoring' departments and industries. Ministers wanted to have some control over the running of public corporations. Yet controlling 505 electricity and 1,046 gas companies might be a time consuming business. To give a very simple example: had the minister intended to instruct each gas company not to increase tariffs before the passage of the Gas Act 1948, he should have signed and dispatched over one thousand letters. Thus the patchwork of electric and gas industries was a barrier to *effective* ministerial control. As Lord Brand remarked

... we are all getting day by day more aware of the difficulties of extending Government control and planning over the vastly complex structure of our industry, ...¹¹⁹

¹¹⁵The Economist, 8 December 1945, page 837.

¹¹⁶C.D. Foster: *op. cit.*, page 74.

¹¹⁷The Economist, 1 November 1947, page 732.

¹¹⁸The Economist, 16 November 1946, page 778.

¹¹⁹Lord Brand: *Private Enterprise and Socialism* In: *The Economic Journal*, No. 231., Vol. LVIII., September 1948, page 316.

As a rule, the more complex structure an industry has, the more time and energy would be needed to keep it under direct ministerial control. As far as the ministry was concerned, reorganisation was a cost-saving exercise: the setting up of monopolies was expected to reduce the future cost of 'supervising' electric and gas undertakings.

The 'Monopoly is beautiful' and the 'Monopoly is easier to control' arguments bore fruits: the Electricity Act 1947 and the Gas Act 1948 created local monopolies. Undertakings were merged into fourteen electricity and twelve gas area boards. The other two branches of public utility services were also monopolised: Telecommunication was re-organised as a national monopoly earlier (Telegraph Act 1869), the water services much later (Water Act 1973). To conclude, national (telecommunication) or local (electricity, gas and water) monopolies provided utility services in Britain.

The classic recipe for utility nationalisation looks like as follows:

Enterprise Cake

serves millions of customers

Preparation time: some months ¹²⁰*(depending on parliamentary time)*

Ingredients:

Utility industries;
Parliamentary majority; and
Political propaganda to decorate.

Method:

- Take the telecommunication, electricity, gas or water sector;
- Create some area Boards;
- Pour one industry into one (telecommunication), fourteen (electricity), twelve (gas), or ten (water) Boards and let them rise for some decades.

Serving suggestions:

- Give a piece of cake to everybody who requests one;
- Only you may prepare 'Enterprise Cake'.

¹²⁰For example, the Electricity Bill was published in January 1947 and passed seven month later in August.

Whether a different 'Method' is needed to prepare 'Privatisation Cake' will be examined in Chapter 4.; the discussion below will concentrate on 'Serving suggestions'.

'Serving suggestions' are concerned with the so-called Social Contract. It may be useful to define what this term means.¹²¹

Utility enterprises operated as truly natural monopolies after nationalisation: the state acquired complete monopoly in the telecommunication, electricity, gas and water sectors.¹²² As a rule, area boards were *de facto* monopoly suppliers: no other undertakings offered utility services to the general public in the UK. The telecommunication and gas suppliers were also *de iure* monopolies: the Post Office Act 1969 and the Gas Act 1972 provided that British Telecommunication and the British Gas Corporation had the **exclusive privilege** of running telecommunication systems or of supplying natural gas in Britain. Had the Post Office (later British Telecommunication) or British Gas Corporation selected new customers on the basis of some economic criteria ("cherry picking"), who would have supplied customers whose request for supply was refused? Hence monopoly came with the requirement that Boards "had to provide a service to all"¹²³ (**Universal Services**). As a rule, nationalised enterprises had statutory monopoly status, but were expected to discharge social obligations, including the obligation to provide universal services (**Obligation to supply**). This was the original model of Social Contract: statutory privileges, most important of all, **monopoly status** in exchange for the obligation to provide **Universal Services**.

The point here is that competition was inconsistent with the original model of Social Contract. Nationalisation was not a pro-competition policy. As Anthony Ogus remarks,

... a degree of scepticism of the merits of competition developed, particularly in relation to water and gas, as the duplication of facilities funded by major capital outlays and often with surplus capacity, was perceived to be wasteful.¹²⁴

It was mentioned above that nationalisation created (un)natural monopolies in the telecommunication, electricity, gas and water sectors. There was no competition: a customer could not choose which telecommunication, electricity, gas or water board should supply her/his home. Only one supplier operated per region (electricity, gas and water) and there was only one telecommunication enterprise¹²⁵ in the UK. Thus customers had no choice after nationalisation. However (s)he could take it for granted

¹²¹ A version of this discussion has been published in: Util. Law Rev., 8(4) Jul - Aug 1997, pages 109 - 113. See Appendix 1.

¹²² David Coombes: State Enterprise (1971), page 22.

¹²³ C.D. Foster: Privatization, Public Ownership and the Regulation of Natural Monopolies (1992), page 78.

¹²⁴ Anthony I. Ogus: Regulation (1994), page 265.

¹²⁵ The special status of Hull may be ignored here.

that (s)he would get a supply upon request (obligation to supply). This is what 'Serving suggestions' are about: only nationalised Boards may prepare 'Enterprise Cake' (statutory monopoly); but the Boards must give a piece of cake to everyone (Universal Services).

The role of competition in the utilities sector changed fundamentally after privatisation: the telecommunication, electricity, gas and water services were liberalised. What is the reason for referring to liberalisation in this chapter? Liberalisation is an example of government interference. As Professor Prosser points out, "... the government has had a key role in determining the amount of competition" in the utilities sector.¹²⁶ Indeed, it was the Secretary of State (as opposed to the regulators) who phased in competition in the telecommunication, gas and water sectors. This point will be explored further below.

As a rule, the Telecommunications Act 1984, the Gas Act 1986, the Electricity Act 1989 and the Water Act 1989 did not specify how many licensees shall provide utility services after privatisation. Hence the government determined the number of licences, authorisations, appointments [hereinafter: licences]. Two procedures were used in Britain:

(i) Negotiation

As was mentioned in Chapter 1., the right to issue the initial licences was reserved for the Secretary of State under the privatisation Acts. The post-privatisation structure of the telecommunication, gas, electricity and water industries was settled in negotiations between the government and the successor companies to the nationalised boards. Important concessions were made during this process to guarantee the success of utility flotations. The best example is the telecommunication sector. Having licensed British Telecommunication Plc. and Mercury Telecommunications Ltd., the government pledged not to issue further licences until 1991. The official reasons for maintaining a 'duopoly' in telecommunication were that (i) British Telecommunication would need some time to adjust to market conditions and (ii) Mercury should be protected from competition for an initial period. This thesis is not concerned with the validity of these arguments. The point here is that the Telecommunications Act 1984 did not envisage that only two companies will be licensed after privatisation: the government decided that only BT and Mercury might offer telecommunication services to the public. The 'duopoly' - policy had no statutory foundation whatsoever; but this policy blocked the liberalisation of the telecommunication services for a number of years in Britain.

¹²⁶Tony Prosser: *Law and the Regulators* (1997), Oxford University Press, page 60.

(ii) Delegated power

The Competition and Service (Utilities) Act 1992 delegated important competition issues to the Secretary of State in the (a) gas and (b) water industries.

(a) Gas industry

It is well known that British Gas plc. had a statutory monopoly to supply premises taking less than 25,000 therms per annum after 1986. Section 8A(1) of the Gas Act 1986, as amended under the 1992 Act, provides that the Secretary of State may modify or remove the '25,000 therm limits'. Such limits are referred to as the 'monopoly threshold' in the gas sector. Such powers were used in 1992 to modify the 25,000 therm limits to 2,500 therms in 1992¹²⁷. The 'monopoly threshold' is due to be abolished by 1998.

(b) Water industry

Similar arrangements apply in the water industry. The Competition and Service (Utilities) Act 1992 allowed "inset appointments to be granted not only for green field sites but also for sites supplied with 250 megalitres (1 megalitre = 220,000 gallons) or more water a year."¹²⁸ The Secretary of State may reduce this threshold at any time.

While the idea of increased competition is generally welcome, it should be noted that statutory powers concerning competition in the gas and water industries should have been delegated to OFGAS/OFWAT. It is unfortunate that the regulators seem to have no control over such an important issue as the modification of the 'monopoly threshold'. The Secretary of State is under no obligation to consult the Director General of OFGAS/OFWAT prior to modifying the currently applicable therm/megalitre limits.

The main point here is that the introduction of competition in the gas and water sectors is a political (as opposed to regulatory) issue in Britain. The Secretary of State may modify the 'monopoly threshold' as and when (s)he thinks fit to do so: regulators are not decision-makers so far as the liberalisation of gas and water services are concerned. It is alarming: the opening up of telecommunications, electricity and gas networks to competition raises important regulatory issues. Most important of all, liberalisation challenged the original model of Social Contract: basic principles, like (a) universal services and (b) statutory monopoly, have been re-defined recently. The discussion below will discuss this process in detail.

¹²⁷SI 1992/1751: The Gas (Modification of Therms Limits) Order 1992.

¹²⁸OFWAT: Increasing Competition in the Water Industry (Information Note, No. 10.), April 1992 (Revised April 1996).

(a) *Universal Services*

As a rule, Universal Services were never universal; the obligation to provide services to all was subject to statutory exceptions. Dunn J. introduced a non-statutory exception in **Woodcock v. South West Electricity Board [1975] 1 W.L.R. 983**: supply obligations do not extend to unlawful occupiers. A request for supply might be refused if, and only if, it failed to satisfy a two-tier test: the request for supply must be *reasonable*; and the provision of services must meet certain conditions which varied from industry to industry. For example, British Telecommunication could legitimately refuse a request for supply if it was *impracticable* or not *reasonably practicable* to provide telecommunication service¹²⁹; British Gas Board was obliged to give a supply of gas if it was *economical* to do so¹³⁰; while Scottish electricity boards were to provide electricity services so far as it was *practicable*.¹³¹ Thus different let-out clauses applied in different industries.

Privatisation would have been an ideal occasion to reconsider whether Universal Service obligation should be qualified after the disposals; and if yes, whether the legislator should use the same vague terms. But neither of these points received much attention: the new gas and telecommunications Acts simply repeated the relevant provisions of the nationalisation statutes. As was mentioned in Chapter 1., the same term ('economical') qualifies the obligation to supply under the Gas Act of 1948 and of 1986; and the same conditions ('impracticable or not reasonably practicable') appear in the British Telecommunications Act 1981 and in the Telecommunications Act 1984. These provisions were also mirrored in the licences issued to British Gas plc. and British Telecommunication plc. respectively. A new qualification was introduced in the electricity industry: 'practicable' was replaced with the '*reasonable in all the circumstances*' condition.¹³² To conclude, the idea of Universal Services and the historical limits to the provision of such services "have in general been carried into privatization."¹³³

Thus the obligation side of Social Contract did not change much after privatisation. Both nationalised and privatised utilities shall supply customers on request; the ownership of telecommunication, electricity, and gas companies is irrelevant to their being obliged to provide Universal Services. The obligation to supply is subject to the same exceptions under nationalisation and privatisation Acts. But profound changes happened as far as privileges of the utility companies were concerned.

¹²⁹Section 3(1) of the British Telecommunications Act 1981.

¹³⁰Section 2. of the Gas Act 1972.

¹³¹Section 3(2) of the Electricity (Scotland) Act 1979.

¹³²Compare Section (3)(2) of the Electricity (Scotland) Act with Section 17(2)(c) of the Electricity Act 1989.

¹³³C. D. Foster: Privatization, Public Ownership and the Regulation of Natural Monopoly (1992), pages 111. and 292.

(b) *Farewell to monopoly*

Statutory privileges arising from the original Social Contract were first altered under the Telecommunications Act 1984. A new supplier, Mercury Communications Ltd., started to run telecommunication services as from 8 November 1984. Similar developments happened in the gas and electricity sectors: alternative suppliers were licensed under the Gas Act 1986 and the Electricity Act 1989. Competition between privatised utilities and new entrants was limited immediately after privatisation. British Telecommunication plc. had only one major competitor in 1984; while the newly licensed energy companies were authorised to supply certain groups of customers: i.e. those consuming more than 25,000 therms of gas a year (monopoly threshold) or having a peak electricity demand greater than 1 MW (franchise limit). The historical importance of this embryonic competition is that after privatisation British Telecommunication plc., British Gas plc. and the regional electricity companies had less privileges than their nationalised predecessors: they were perhaps *de facto* but certainly not *de iure* monopolies. Thus one condition of Social Contract was gone: the privilege of statutory monopoly was abolished. Was the other condition (social obligations) also adjusted ?

As far as obligations are concerned, the main provisions of the new Social Contract may be summarised as follows:

- After privatisation British Telecommunication plc., British Gas plc. and the regional electricity companies retained the obligation to supply;
- With the exception of electricity, the legislator did not amend the terms of the supply obligation: privatised utilities and their nationalised predecessors had the same 'excuses' to refuse a request for supply; and
- New licensees were not saddled with supply obligations. The licence issued to Mercury Communications Ltd. did not include the Universal Telecommunication Services condition¹³⁴. New market players need not bother about Social Obligations in the gas and electricity industry; the franchise limit/monopoly threshold barred them from supplying low user, high cost customers.

Economists seem to be content with this arrangement. They argue that the above outlined rules intend to forge competition and the incumbent suppliers have great advantages "which do not offset the disadvantage of facing universal service obligations"¹³⁵. This thesis does not discuss the validity of these arguments. It simply notes that privatisation statutes replaced the original model of Social Contract

¹³⁴ Compare Condition 50. of the Mercury licence with Condition 53. of the British Telecommunication licence.

¹³⁵ Philip Cullum: Consumer Rights for Utility Services In: Centre for the Study of Regulated Industries: Universal Service Obligations: A Policy Review (1996), page 10. and OFFER: The Competitive Electricity Market from 1998: Customer Protection, Competition and Regulation (November 1995), page 8., point 3.8.

(monopoly rights *in exchange for* the obligation to provide Universal Services) with Social Contract No. 2. (no statutory monopoly *but* obligation to supply). The main point here is that rights and obligations do not seem to be balanced after privatisation: the privilege had been taken away (no monopoly rights); but the obligation remained intact (see point A./ above). Will a liberalised market re-balance rights and obligations?

Future of Social Contract

Will *liberalised* markets have a Social Contract ? It is generally presumed that *free* markets would need no such contract. Some commentators concluded from this presumption that the obligation to supply may be abolished¹³⁶: such obligation would be "anomalous with the competitive market"¹³⁷ and would distort competition.¹³⁸ Professor Prosser dissented in an article published in the *Utilities Law Review*. He argued that (i) ". . . social dimension to utility regulation has become absolutely central to regulatory performance and credibility." and (ii) ". . . relationship between privatisation, regulation, and the provision of what are still widely seen as public services with a social dimension will be a key question of regulation in the next few years."¹³⁹ Thus two views may be observed in the literature: (a) Demise of Social Contract: the obligation to supply may be abolished. and (b) Rise of Social Contract: the future of supply obligations will be the key question of utility regulation.

Regulators did not stay aloof from the debate concerning the future of Social Contract. It is unfortunate that OFTEL, OFFER, and OFGAS do not have a uniform approach: the three offices seem to advocate three different views as to how Social Contract No. 2. should be amended.

Telecommunications

The Director General of OFTEL does not intend to re-draft Social Contract No. 2. until 1999 at the earliest. Don Cruickshank argues in a recently issued discussion paper that "the current net cost involved in the provision of universal service in the UK is not proven and does not justify setting up a universal service funding mechanism in the short term."¹⁴⁰ The government agrees with the regulator: DTI told the Select Committee on European Legislation that "the cost to BT and Kingston Communications of meeting their universal service obligation is likely to [be] very low or of a *de minimis* nature. As a result it is possible that the UK may choose not to set

¹³⁶ Andrew Holmes: *Privatising British Electricity* (1992), pages 116 - 117.

¹³⁷ Stephen Dow: *Licensing of the Gas Supply Industry under the Gas Act 1995*. [1996] 7 *Util LR* 31., at 34.

¹³⁸ OFFER: *The Competitive Electricity Market from 1998: Customer Protection, Competition and Regulation* (November 1995), page 5., point 2.17.

¹³⁹ Tony Prosser: *Utilities and Social Regulation* [1994] 5 *Util LR* 156.

¹⁴⁰ OFTEL: *Universal Telecommunications Services. Proposed Arrangements for Universal Service in the UK from 1997* (1997).

up a universal service funding scheme in the immediate future."¹⁴¹ Thus Universal Service obligation, and its financial burden, if any, are to remain with British Telecommunication plc. for the time being.

To conclude, rights and obligations are not balanced in the telecommunication sector after liberalisation: British Telecommunication plc. has no monopoly rights but must provide Universal Services. Yet no new Social Contract will be drawn up here in the near future; according to OFTEL there is no undue financial burden on BT arising from Universal Services obligation.

Electricity Industry

As was mentioned above, second tier licensees are not subject to statutory supply obligations for the time being. After some hesitation OFFER proposed to modify Social Contract No. 2. in the electricity sector: similar obligations will apply to the second tier suppliers as presently apply to public electricity suppliers after 1998. Condition 22. of the draft Standard Second Tier Electricity Supply Licence requires the licensee to supply domestic customers on request.¹⁴² As far as the financing of Universal Services is concerned, OFFER seem to be in complete agreement with OFTEL: no action is necessary for the time being. According to the Director General of OFFER, the public electricity suppliers should meet the costs of Social Services until 1998. The Office is currently considering what financing regime shall be in place after that date: the preferred solution seems to be the introduction of a small levy which would be charged on customers.

Thus proposed changes in the electricity sector seem to echo the original principles of Social Contract: rights and supply obligations shall be balanced out. If second tier suppliers were to supply any customer they have to shoulder social obligations.

Gas Industry

In the case of the two industries mentioned above, the regulators attempt to adjust Social Contract No. 2. to the needs of liberalised markets; it is the legislator who has set out new social arrangements in the gas sector. While the basic principle is the same here as in the electricity sector (i.e. each licensee must supply customers on request), a unique system is emerging under the Gas Act 1995.

(1) Statutory obligation to connect

Public Gas Transporters are obliged to *connect* premises under Section 4 of the Gas Act 1995. Compared with the 1986 statute, the scope of this obligation is broader in two respects: (i) Transporters are to connect **any premises** (1986 Act: premises

¹⁴¹ Select Committee on European Legislation: Sixteenth Report, 14. Telecommunications: Financing of Universal Service, HC 36-xvi 1996-97, section 14.7.

¹⁴² OFFER: The Competitive Electricity Market from 1998. Standard Second Tier Electricity Supply Licence (for Scotland) Draft: January 1997.

which are (a) situated within 25 yards from the main or (b) connected to any such main) if the service pipe is supplied and laid, or proposed to be supplied or laid, by the owner or occupier; and (ii) a customer may request a supply of gas up to **75,000 therms** (1986 Act: up to 25,000) per annum. The obligation to connect is subject to the usual two-tier test, i.e. (a) reasonable request and (b) whether it is economical to supply.¹⁴³ But, and this is the main point here, the Gas Act 1995 does not provide for a statutory obligation to supply customers.

(2) New exceptions

The obligation to supply does not appear in the legislation: it is Condition 2. of the Standard Conditions of the Gas Suppliers' Licences which require a licensee to supply every potential domestic customer which is connected to a relevant main. The Standard Conditions set a new exception to the obligation to supply. A licensee is not obliged to supply at new premises "*if and so long as to do so would significantly prejudice its ability*" to supply existing domestic customers.¹⁴⁴ This new qualification does not appear to be more down-to-earth than the old (a) reasonable request and (b) economical to supply - conditions. The Director General of OFGAS will be in an unenviable situation when she will be called to interpret terms like 'prejudice' and 'ability'.

(3) Financing of Universal Services

As was mentioned above, OFTEL and OFFER do not seem to have definite plans as to how Universal Services shall be financed in the future; both Directors General will review the current arrangement (i.e. the costs of Universal Services fall on British Telecommunication plc. and the public electricity suppliers) in 1999 and in 1998 respectively. Out of the three Directors General it was the DG of OFGAS who took the plunge: the Standard Conditions of the Gas Suppliers' Licences revolutionized the financing of social obligations. If certain conditions are met, as determined under Condition 6(2) of the Standard Conditions of the Gas Suppliers' Licences, a licensee may make a Special Customer Payment Claim. Unless the Secretary of State or the Director General of OFGAS would decide that the claim is unjustified, the Public Gas Transporter will (i) make a payment to the supplier and (ii) in turn increase its charges for the conveyance of gas.¹⁴⁵ This arrangement will not be operative before 1999.

To conclude, rights and social obligations will be re-balanced in the gas industry: each licensee will have (i) the right to supply any customer and (ii) the obligation to provide Universal Service. A special funding scheme is due to be introduced in the British gas industry to finance the costs of Universal Services.

¹⁴³Section 9(1)(b) of the Gas Act 1986 as amended under Section 3 of the Gas Act 1995.

¹⁴⁴Condition 7(3) of the Standard Conditions of the Gas Suppliers' Licences.

¹⁴⁵Condition 10(1)(a) of the Standard Conditions of the Gas Transporters' Licences.

(c) *The European dimension*

If the three above mentioned regulators do not agree on the financing of Universal Services in Britain, do the fifteen Member States of the EU have a better prospect of forming a uniform position on the same matter ? Not really. The first and most important problem at the European level is that "neither the concept nor the scope of the [public service] obligations is in any way harmonized between the Member States."¹⁴⁶ A prolonged debate about the future of the Social Contract could thwart the liberalisation of the EU telecommunication, electricity, and gas markets; thus the relevant Directives try to say as little as possible about public service requirements. For example, the first **telecommunication** Directive (90/388/EEC) was reticent about social obligations. Principles of Universal Services were set out eventually in a Council Resolution (94/C 48/01); and it was Directive 96/19/EC which laid down rules in connection with the financing of Universal Services. The main point of this Directive is that the National Regulatory Authority is to determine whether a Universal Service financing scheme is required or not. If such a scheme is introduced it must operate in accordance with Community Law; the Commission is to review the financing schemes no later than 1 January 2003. As was mentioned above, OFTEL decided that Universal Service funding is not required in the UK; thus Community Law on financing schemes does not apply to British telecommunication operators.

The recently passed **electricity** Directive (96/92/EC), and the draft **natural gas** Directive (COM(93) 643 final) do not discuss Social Obligations in detail. Although the Economic and Social Committee stressed that "the 'public service' obligations of these sectors cannot be overlooked"¹⁴⁷, the documents mentioned merely declare that Member States may impose on distribution companies an obligation to supply. Hence the electricity Directive does not seem to require further action from the UK government in connection with social obligations: the two cornerstones of the proposed system (obligation to supply will extend to every supplier; while financing of Universal Services will not be reformed until 1998) are consistent with Community Law. Attention is now focused on the natural gas proposal. The latest draft seems to mirror the Electricity Directive; thus the gas Directive will have limited impact in the UK. The Standard Conditions of the Gas Suppliers' or Transporters' Licences are likely to satisfy the EU requirements as set forth in the draft Directive.

However the electricity Directive and the draft natural gas Directive may not be the last documents from the EU on Social Contract: the Economic and Social Committee noted that "... the present proposals represent a compromise which will have to be fine-tuned as the proposed process of aligning the operating conditions in both sectors progresses and as experience is acquired in operating the internal market in these

¹⁴⁶Opinion from Economic and Social Committee on Common rules for the internal market in electricity and natural gas (94/C 195/24) OJ No C 195, 18. 7. 94, p. 82, point 4.3.

¹⁴⁷Opinion from Economic and Social Committee on Common rules for the internal market in electricity and natural gas (93/C 73/10) OJ No C 73, 15. 3. 93, p. 31, point 2.2.6.

sectors under these conditions."¹⁴⁸ As a result of 'fine-tuning', a European Social Contract is likely to emerge in the electricity and natural gas sectors; details of that arrangement are not available for the time being.

The EU position on social obligations may be summarised then as follows: (i) As a main rule, Directives do not discuss public service obligations in detail. (ii) Community Law on the financing of Universal Services in the telecommunication sector does not apply in the UK; OFTEL decided that no financing scheme is required. (iii) The OFFER proposal for the liberalisation of the UK electricity market harmonizes with the electricity Directive. The proposed natural gas Directive is likely to have limited impact in the UK gas sector.

The main points of the above discussion may be re-stated as follows:

The original model of Social Contract intended to balance out supply obligations and monopoly rights. Yet rights and obligations do not go hand in hand after privatisation: statutory monopoly of the incumbent telecommunication, electricity, and gas suppliers was abolished, nevertheless they have to provide Universal Services (Social Contract No. 2.). The final point here is that the third generation of Social Contract will govern liberalised markets: market players may supply **any** customer but must provide services to **all**.

Conclusion

Chapter 1. concluded that privatisation did not break the political link in the utilities sector. It was argued that the competent Secretary of State is the 'regulator' of the regulators; he may and does meddle in regulatory affairs. This Chapter has attempted to show that utility regulation is not the only venue for government intervention. Three legal instruments of government interference have been analysed in Parts I. - III.; while Part IV. discussed how the government phased in competition in the utilities sector.

As far as the former is concerned, the main point is that there were three main forms of government interference after privatisation: only one exists as of today.

Residual stakes and **government-appointed directors** failed for the following reasons:

- Residual shares and government directors faced an uncertain future from the start: (i) the government could NOT control privatised companies through residual shares; and (ii) government nominees worked in a legally impossible situation. As a rule, government-appointed directors had little 'perceptible impact' in Britain. Existing government holdings were sold off after 1984; and no significant new holdings were retained after 1991. Thus the importance of **residual stakes** diminished; and **government-appointed directors** suffered a similar fate. After

¹⁴⁸ Opinion from Economic and Social Committee on Common rules for the internal market in electricity and natural gas 94/C 195/24 OJ No C 195, 18. 7. 94, p. 82, point 3.3.

the sale of residual stakes the government had no right to delegate directors to the boards of privatised companies.

- Thus **Golden Shares** gradually exceeded residual stakes and government directors in importance. This process peaked in late 1993: only two stakes of significant size remained, while the government held Golden Shares in some forty companies.

Legal instruments of government interference have a different story on the Continent. Compared with Britain, the three principal forms of government interference are interlinked on a different basis in Europe. The right to appoint **directors** is not derived from holding a certain percentage of the voting capital (**residual shares**); it is the inherent privilege of the holder of the **Golden Share**. Hence Golden Shares and government-appointed directors co-exist in Europe.

The discussion above has identified two further differences between European and British privatisation practices: (i) Governments tend to sell a minority stake in utilities and in companies of 'special' importance in Europe. Thus significant residual stakes are retained after privatisation. (ii) Government-appointed directors have a well-recognized role in Europe. They work on the supervisory (as opposed to management) boards; they serve as a two-way information channel between companies and ministries.

Thus European governments have at least three channels to interfere with the operation of privatised companies.

Turning to the introduction of competition, the main point is that liberalisation has been a 'managed' process in the UK. It was the Secretary of State (as opposed to the regulators) who phased in competition in the telecommunication, gas and water sectors. With the exception of OFFER, the regulatory offices had little influence over the liberalising of utility industries. Thus the liberalisation of utility services is a further example of government interference.

Chapter 3.

Judicial Review of Regulatory Decisions

The regulation of privatised utilities has expanded the scope of administrative orders susceptible to judicial review: decisions of the utility regulators, namely OFTEL (set up in 1984), OFGAS (1986), OFWAT (1989), and OFFER (1990), may be challenged before the court. Yet there were not many applications for judicial review after the British Telecom (year of privatisation: 1984) and British Gas (1986) flotations. No boom in the number of applications followed the sale of the English/Welsh water (1989) and the UK electricity (1990 - 1991) companies either. Thus the regulation of privatised utilities was a 'judicial review-free' area up until the early 1990s; and then the number of applications started to rise. More regulatory orders were challenged between 1995 - 1997 than between 1984 (OFTEL, the first utility regulator, established) and 1994. Commentators argue that "there will be more court cases in the future"¹; according to Colin Scott, increased judicial review will be one offshoot of liberalisation.² This is not what the legislator intended; the Tory government tried to keep the courts out of the regulatory game.³ This Chapter will analyse why judicial review is getting fashionable after privatisation.

The structure of this Chapter will be as follows: Part I. will make some general points about judicial review. Judicial review procedures will be examined in Part II. Finally, Part III. will present an economic analysis of law; this discussion will conclude that judicial review may not be the most efficient procedure to settle disputes between regulators and regulatees.

Part I.

General comments on judicial review

Judicial review is the main dispute resolution technique in the post-privatisation regulatory regime. It is easy to see why the courts may review decisions of the utility regulators:

- OFTEL, OFFER, OFGAS etc. are 'public bodies';
- it is a fundamental principle of British administrative law that decisions of public bodies may be challenged before the court (judicial review); thus

¹Cosmo Graham: *Judicial Review and the Regulators* [1997] 8 Util LR 107.

²Colin Scott: *The Juridification of Regulatory Relations in the UK Utilities Sector* (paper for presentation at LSE - Brick Court Seminar Series, 22 April 1997), page 6.

³C.D. Foster: *Privatization, Public Ownership and the Regulation of Natural Monopoly* (1992) Blackwell, page 107.

- decisions of the single-industry regulatory offices should be susceptible to judicial review.⁴

Regulators and regulated utilities are not the only participants of the regulatory game: customers may also wish to seek legal remedies. What forms of appeal are available? As was discussed under Chapter 1., Part I., B.3, if a customer is dissatisfied with the services of a privatised utility (s)he should apply for judicial review. It was also noted there that, according to de Smith, a dissatisfied customer may not sue the utility directly; (s)he may obtain

a remedy indirectly by bringing proceedings against the regulatory body if it fails to take appropriate action to ensure that the privatised body does not act improperly.⁵

So far as customer protection is concerned, this arrangement is unsatisfactory; the reasons for this have been explained in Chapter 1. above. What should be underlined here is that customers may NOT bring ordinary proceedings against privatised utilities; judicial review seems to be the sole remedy available. Why should it be so? This is not a simple question; the following example may help to appreciate why:

You and your neighbour receive a notice from a local gas distribution company: the gas supplier would like to connect your farms to the natural gas network. You turn down the offer and carry on heating your house by LPG (liquefied propane gas). Your neighbour is fed up with LPG and switches to natural gas. You and your neighbour fly to Barbados for a short break next winter. It is freezing cold outside when you arrive drive home the airport. Both of you try to switch on the gas heating in vain. What happened?

The gas distributor has cut off the supply to your neighbour's farm. The gas company refuses to re-connect your neighbour unless and until certain charges are paid. He complains to OFGAS, but the regulator finds in favour of the gas company.⁶

Your LPG container is empty. The LPG distributor should have filled it up on 15 January, but failed to do so.

Both of you are angry and would like to appeal to the court. What legal remedies are available?

The story of your neighbour has been discussed above: he may seek judicial review. As was mentioned, his only option is to bring proceedings against OFGAS. It will be

⁴ de Smith, Woolf & Jowell: *Judicial Review of Administrative Action* (Sweet & Maxwell, 1995), para. 3-046.

⁵ *op.cit.*, para 3-046.

⁶ *Regina v. Director General of Gas Supply & Another, ex parte Smith and another* (QBD), LEXIS, 31 July 1989.

explored below what remedies the court may grant. It will also be examined whether judicial review is the most satisfactory procedure to settle disputes between disappointed customers (like your neighbour) and utilities.

So far as the LPG user is concerned, the story is straightforward. You would have a contractual claim against the LPG distributor: your container should be filled up on the 15th of each month under the service agreement. You might claim damages, specific performance, etc. if applicable.

Who is in a better position then - your neighbour or you ? It will be a main theme of this chapter that disappointed customers would prefer ordinary litigation to judicial review. The point here is that, compared to ordinary litigation, judicial review seems to be a less attractive option; and this is for the following reasons:

- the judiciary is reluctant to be involved in the economic regulation of public utilities (3.1);
- judicial review may be sought on limited grounds only (3.2);
- remedies are not likely to satisfy applicants (3.3); and
- if judicial review is granted, the matter would be remitted to the same regulator for further consideration (3.4).

Each of these points will be discussed in turn below.

3.1 Judicial attitude towards regulatory decisions

The starting point here is that judges regard judicial review as an extraordinary procedure; this remedy will be granted in exceptional circumstances only. Three cases may be mentioned here to illustrate that point:

- **Regina v. Monopolies and Mergers Commission and another, ex parte Argyll Group Plc. [1986] 2 All ER 257 CA**

The Court of Appeal was asked to quash an ultra vires act of the chairman of MMC.⁷ Sir John Donaldson, MR pointed out that the judicial power to grant a remedy sought is discretionary. In this particular case discretion was exercised in the light of the "proper awareness of the needs of public administration"⁸; and the remedy was not granted.

⁷ See **R. v. Panel on Take-overs and Mergers, ex parte Guinness Plc. [1989] 1 All ER 509 AC**, at 526-D. ". . . this court [Court of Appeal] found that the chairman of the Monopolies and Mergers Commission had acted wholly without jurisdiction, but refused to quash his order [in the Argyll - case]."

⁸at 266-C.

- **Regina v. Civil Service Appeal Board, ex parte Bruce [1988] 3 All ER 686**

This case was concerned with the dismissal of an executive officer from the public service. Mr. Bruce applied for judicial review claiming that provisions of the disciplinary code had not been complied with. The court found that the applicant was entitled to judicial review but declined to grant a remedy: an alternative remedy existed.

- **Regina v. Panel on Take-overs and Mergers, ex parte Guinness Plc. [1989] 1 ALL ER 509 CA**

This decision by the Court of Appeal reinforced the point that judicial review of administrative decisions is a supervisory or 'longstop' jurisdiction. The court will interfere with administrative decisions when "all avenues of appeal have been exhausted, at least in so far as the alleged cause for complaint could thereby be remedied."⁹

Two points should be emphasized here:

- (i) Discretionary remedy

Judicial review is a discretionary remedy. As Sir John Donaldson, MR underlined in Argyll Group it is up to the court whether a remedy will be granted or not. The general trend seems to be that judges try NOT to grant judicial review: Bruce is as example. As a main rule, judges in Britain are reluctant to rule on administrative decisions; de Smith refers to this approach as 'judicial self-restraint'.¹⁰

One may argue that the independence of the judiciary would be in danger if judges were involved in administrative decision-making. As Simon Brown LJ pointed out recently, judges are "to remain within their constitutional bounds and not to trespass beyond them."¹¹ The regulation of monopolies is the domain of the legislator and/or the government. Hence it would be unfortunate if the judiciary were to attempt to interfere with the operation of these branches of government.¹² Judges are becoming very sensitive on this point: as Lord Diplock put it in **Duport Steels Ltd. v. Sirs** [1980] 1 All ER 529, "... Parliament makes the laws, the judiciary interpret them."

⁹Guinness - case, at 526

¹⁰ de Smith, op. cit., para.1-009.

¹¹**R. v. Ministry of Defence, ex parte Smith and other applications** [1995] 4 All ER 427, at 448-B.

¹²In Hungary, for example, a local court recently ruled that road tolls charged by a private concession company are not proportionate to services provided. This interference in the regulation of toll charges will have unforeseen consequences as far as future highway projects are concerned. See: <http://www.nepszabadsag.hu> - 20 November 1996.

For example, Sir Robert Megarry V.-C. commented in **Estmanco Ltd. v. Greater London Council (Vac. Ct) [1982] 1 W.L.R. 2** that

Provided a local authority complies with the law, matters of policy on housing, as on other things, are matters for decision by that authority, and not by the courts.¹³

The policy of non-interference has a long tradition in other branches of law as well. For example, it is a well-accepted principle in company law since **Foss v. Harbottle (1843) 2 Hare 461**. Professor Pennington writes that the refusal of the courts to interfere in the management of a company

is an obvious necessity, because it cannot be the court's function to take management decisions and to substitute its opinions for those of the directors and the majority of members.¹⁴

The courts are unhappy "to undertake to review matters of commercial judgement or policy or of internal administration".¹⁵ Regulatory decisions always involve commercial and political factors. The rule in **Foss v. Harbottle** and the comment from Sir Robert Megarry V.-C. quoted above are similar: if the courts may "not be required on every occasion to take the management of every Playhouse and Brewhouse in the Kingdom."¹⁶ why should the judiciary pursue a different policy when regulatory orders are challenged? A departure from this conservative, purely supervisory standpoint would lead to a re-distribution of power between the regulators, the regulated, and the judiciary. Such a change would upset the basic constitutional position. As Rene David put it,

... The security of legal relations and the supremacy of the law would be threatened if judges were willing to bring the rules of established law back into question ...; the English judiciary has clearly indicated, in striking language, its determination not to do so.¹⁷

It was the idea that 'rules of established law' should not be questioned which precluded the setting up of a Constitutional Court in Britain. A comparative comment should be made here: there is a marked contrast between the UK and mainland Europe on this point. Constitutional courts were established in many Central and Eastern European countries after the collapse of what was labelled as 'communism'.

¹³at 7- H and 8- A.

¹⁴ Pennington's Company Law (1990), page 648

¹⁵ L.S. Sealy: Cases and Materials in Company Law (1992), page 452

¹⁶ **Carlen v. Dury (1812) 1 Ves & B 154** at 158, quoted in L.S. Sealy: Cases and Materials in Company Law (1992), page 452

¹⁷Rene David and John E.C. Brierley: Major Legal Systems in the World Today (Stevens & Sons, 1985), page 328.

There was a general belief that no Rule of Law may be introduced without the establishment of constitutional courts. They were wrong. The Rule of Law is a British idea: that country never had special administrative tribunals, let alone a constitutional court. Actually, it was Germany which set up the first, modern constitutional court after World War II. All the Central European countries followed the German model. The irony of ironies was that the advocates of constitutional courts in Central and Eastern Europe were using English terminology ('Rule of Law') and were referring to British authors (e.g. A.V. Dicey); they argued for the transplantation of an idea that was and will be unacceptable in Britain (i.e. the German-style constitutional court). Some countries went one step further. They tried to refine the German model; with disastrous result. The best example is Hungary, perhaps.

The Hungarian Constitutional Court has broader jurisdiction than any other court in the world: it may rule about the constitutional status of (i) a Bill presented to the Parliament, (ii) an Act passed by Parliament and submitted to the President for signing, and (iii) any Act, Degree or other sources of law in force. A new Finance Minister was elected in 1995 who tried to introduce an austerity package to slow down inflation in Hungary. He urged the government to amend fundamental Acts, like the budget and the Social Security Act. His proposals were referred to the Constitutional Court; all of them were declared unconstitutional just before certain Bills passed to implement such proposals would have come into force. The Constitutional Court ordered the Ministry of Finance to prepare new proposals. Economic reforms had come to a standstill. As a journalist commented in the local press, something was fundamentally wrong here: is it the Rule of Law when the Minister of Finance is reading judgements, while the Constitutional Court is preparing the budget?

What is the moral from the Hungarian story? There is a lot to be said for 'judicial self-restraint'. Should the judiciary take an active interest in executive and legislative decisions, basic constitutional principles may turn upside down: it is not for the judiciary to re-draft Acts or to rearrange the budget. It is in the best interest of modern administration that judicial review should be kept within limits. This is not to say that judicial self-restraint is the best arrangement available. It will be argued below that potential applicants do not appeal to the UK courts for help: they do not believe that judicial review will be granted. Yet 'judicial self-restraint' is certainly better than the pro-active approach which seems to hold sway in Central and Eastern Europe for the time being.

(ii) Last-ditch action

The moral from the Guinness - case is that a regulated company may not seek judicial review if an internal appeal forum is available. As a rule, there are two 'internal appeal forums' in the post-privatisation regulatory regime: (a) the Monopolies and Mergers Commission [hereinafter: MMC]; and (b) the Directors General.

(a) MMC

Privatisation Acts provide that so-called 'Modification references' may be made to the MMC in connection with "any matters which relate to the supply of" utility services.¹⁸ Thus the MMC appears to be the 'main court of appeal'¹⁹ in relation to disputes arising in connection with *licence modification*.

The main rules on licence modification may be summarised as follows:

- licence conditions may be modified at any time by agreement between the regulator and the regulated;
- the regulated does not have the right to require a modification of the licence; and
- the Director(s) General may unilaterally make modifications only following a report from the Monopolies and Mergers Commission authorising her/him to do so. A different solution has been adopted in the water industry: the Water Authority has the right to revoke or to modify a licence. A licensee has no remedy but the right to appeal to the Secretary of State.²⁰

It should be noted, however, that the MMC is not a universal appeal forum; its jurisdiction is limited to issues concerning licence modification. For example, there is no appeal to the MMC when Directors General interpret Acts²¹ or licence conditions²²; and billing disputes may not be referred to MMC either.²³ For example, the applicant could not appeal to the MMC in **R. Director General of Electricity Supply, ex parte Redrow Homes (Northern) Ltd. (QBD)**, LEXIS 3 February 1995; the dispute was about the interpretation of the Electricity Act 1989 (as opposed to licence modification).

To summarise, "the regulatee either accepts the ruling of the regulator or allows the matter [i.e. licence modification] to be referred to MMC."²⁴ Thus disputes concerning proposed licence modifications should be referred to the MMC first; pursuant to the rule in Guinness, judicial review is *not* available until after this internal appeal forum has been exhausted.

¹⁸See, for example, Section 24 of the Gas Act 1986.

¹⁹House of Commons: Trade and Industry Committee: Energy Regulation HC 50-viii. 1996-97, page 247., Q.5.

²⁰Section 52 of the Water Resources Act 1991.

²¹See Redrow Homes - case, discussed under point (2) /B/ below.

²²C. D. Foster: Privatization, Public Ownership and the Regulation of Natural Monopoly (1992), page 284.

²³Aileen McHarg: The Competition and Services (Utilities) Act 1992: Utility Regulation and the Charter In: [1992] P.L. 385, at 392.

²⁴Sir James McKinnon: Conference on Regulatory Reform In: [1993] 4 Util LR 119, at 121.

(b) **Directors General**

The Competition and Service (Utilities) Act 1992 provides that (i) billing disputes²⁵ and (ii) disputes about discrimination²⁶ may be referred to the Directors General. Her/his determination is final and shall be enforced in Scotland "as if it were an extract registered decree arbitral bearing a warrant for execution issued by the sheriff."²⁷

The point here is that a regulated utility or a disappointed customer may NOT appeal to the court for help if the dispute concerned may be referred to the competent Director General (rule in Guinness). Hence the Competition and Service (Utilities) Act 1992 may reduce the number of applications for judicial review: the Directors General will emerge as an important appeal forum in the regulatory game.

To summarise then, there are two 'internal appeal forums' in the post-privatisation regulatory game: (a) the MMC, if proposed licence modifications are in dispute; and (b) the **Directors General**. If (a) the MMC and/or (b) the competent Director General have no jurisdiction, then any party may appeal to the court for help: the rule in Guinness is not applicable if there is no internal appeal forum available.

The discussion about the judiciary's approach to judicial review may be concluded then as follows. Judicial review of regulatory decisions is probably the last true example of judge-made law in the Common law system. The Stair Memorial Encyclopaedia makes the following comment:

... the grounds of judicial control of administrative action have resulted mainly from judicial decisions, not from legislation, and there continues to be scope for further judicial development of the law.²⁸

The judiciary in Britain tends to shape the law with a view to reducing its own involvement to the minimum. What judges have to say about the regulation of privatised utilities is that the game is (i) to be played by reasonable players²⁹ and (ii) for the purposes of the game. Subject to these fairly broad rules, the game may develop in either direction: judges are reluctant to lay down further guidelines. Those who wish to see a more active judiciary in Britain are warned: the newly established constitutional courts in Central and Eastern Europe have upset the basic constitutional

²⁵For example, Section 20 of the Water Industry Act 1991.

²⁶In the telecommunications industry only: Section 5. of the Competition and Service (Utilities) Act 1992.

²⁷Section 27F(7)(b) of the Telecommunications Act 1984, as amended.

²⁸The Stair Memorial Encyclopaedia, Volume 1., para 213.

²⁹The 'obligation to act reasonably' was emphasized in *Bank of Scotland v. Investment Management Regulatory Organisation Ltd.* (Ex. Div.) 1989 S.L.T. 432, at 444-A.

arrangements on more than one occasion - active and politically more sensitive judges may not necessarily deliver 'better' judgements.

3.2. Grounds of Challenge

The grounds on which judicial review may be sought are usually summarised by reference to Lord Diplock's speech in **C.C.S.U. v. Minister for Civil Service [1985] A.C. 374**. The main features of the three headings, (i) illegality, (ii) irrationality, and (iii) procedural impropriety, may be summarised as follows:

- Illegality

The decision-making authority "must understand the law that regulates his decision-making power and must give effect to it."³⁰ What does it mean in the context of utility regulation?

First of all, the Director General must interpret the privatisation statutes correctly when deciding whether (s)he has the power to make certain decisions. Lord Dunpark discussed this point in **Watt v. Lord Advocate (OH), 1977 S.L.T. 130**; a decision of an administrative body may be challenged if the decision-maker

... has wrongly defined the nature and limits of [her/his] statutory duty and ... by not doing something which the statute required [her/him] to do, has not acted in accordance with [her/his] statutory powers.

R. v. Director General of Telecommunications, ex parte British Telecommunications plc. (QBD), LEXIS, 20 December 1996 and **R. v. Director General of Electricity Supply, ex parte Redrow Homes (Northern) Ltd. (QBD), LEXIS 3 February 1995** are examples here. The application argued in British Telecom that it was not within the powers of the Director General of Telecommunications to insert into the BT's licence the so-called Fair Trading Conditions. The court disagreed: Phillips LJ pointed out that

- The DG is empowered and obliged under the Telecommunications Act 1984 to promote competition in the telecommunication sector;
- the licence modification seeking to introduce the Fair Trading Conditions was in accordance with such statutory duties; thus
- the proposal was not ultra vires.

The Redrow - case has been discussed under point 3.2 B./ above: the point to be recalled here is that the Director General of Electricity Supply told the construction company that he had no statutory power to decide certain disputes. The court held

³⁰ C.C.S.U. - case, at 410

that his interpretation was NOT correct: the Director General misconstrued the relevant provisions of the Electricity Act 1989.

- Irrationality

Whenever an authority comes to a conclusion "so unreasonable that no reasonable authority could ever have come to it" the court may quash an administrative resolution. The test of a reasonable tribunal was adopted, for example, in **R. v. Monopolies and Mergers Commission, ex parte Matthew Brown Plc. [1987] 1 All ER 463** : the court rejected the application for judicial review on the basis that the procedure of MMC was not so unfair that no reasonable tribunal would have adopted it.³¹ In **R. v. Secretary of State for Foreign Affairs, ex parte World Development Movement Ltd. [1995] 1 All ER 611** the court applied the test of irrationality and ruled that

... the contemplated development is, on the evidence, so economically unsound that there is no economic argument in favour of the case ...³²

In a recent case the court re-confirmed that a decision of an administrative body may not be quashed unless the applicant can satisfy the unreasonableness test.³³

The main point from Matthew Brown and World Development is that a challenge under the test of 'reasonable authority' or 'sensible person'³⁴ may succeed in the most extreme cases only. **Regina v. Director General of Electricity Supply, ex parte Scottish Power (CA)**, LEXIS, 3 February 1997 is an example. The applicant claimed that a decision of the Director General of Electricity Supply was irrational. While judicial review was granted, the Court of Appeal did not actually rule that the decision was irrational. Hence regulated utilities have limited hope of success under this heading: it is hard to prove that a regulatory offices acted irrationally.

Yet two further points should be considered in connection with 'Irrationality'.

- There is little doubt that this term also covers (i) the unreasonable exercise of discretionary power (e.g. **Maystart Ltd. v. Director General of Telecommunications (CA)**, LEXIS, 17 February 1994), (ii) the taking into account of irrelevant considerations (e.g. **R. v. Director General of Electricity Supply, ex parte Scottish power (CA)**, LEXIS, 3 February 1997), and (iii) the

³¹The approach of the court in Matthew-case has been criticised in de Smith's *Judicial Review of Administrative Action* arguing that reasonableness has no place in relation to procedural propriety. See: de Smith, Woolf & Jowell: *Judicial Review of Administrative Action* (1995), Section 8-011. The issue seem to be open to further discussion for the time being.

³²at 626 - 627.

³³**R. v. Panel on Take-overs and Mergers, ex parte Fayed [1992] BCLC 938 CA**, at 953-D

³⁴C.C.S.U. - case, at 410

failing to consider relevant factors (e.g. **R. v. Director of Passenger Rail Franchising, ex parte Save Our Railways and Others (CA)**, LEXIS, 15 December 1996).

- According to de Smith, one of the principles governing the exercise of official power is that 'legitimate expectation' of the governed must not be thwarted.³⁵ The notion of legitimate expectation is of special importance in the post-privatisation regulatory regime. As was discussed in Chapter 1., secret negotiations are central to utility regulation in Britain. Successful negotiations lead to promises and expectations: concrete steps will follow in due course. It is essential then that promises and expectations may be relied upon in the meantime. The ultimate question whether the law may acknowledge such promises and expectations. Can undertakings from a regulator create 'legitimate expectation' ? For example, the Rail Regulator issued a 'policy statement' in 1994; he set forth criteria OFRAIL would adopt in approving track access agreements. If the Regulator were to disregard those principles at the time when the access agreements are due to be re-negotiated, could a privatised rail company apply for judicial review ? Is the regulator obliged to comply with its own guidelines or policy statement ? Did the 'policy statement' create a 'legitimate expectation' ? Lord Hope addressed this point in **Highland Regional Council v. British Railways Boards 1996 S.L.T. 274**. His Lordship explained that the court should check (i) whether the licensing policy is within the power of the administrator; (ii) if it is, then the court would enforce that policy both against the administrator and the administered.³⁶ Thus, provided that the licensing policy is not ultra vires, the court may grant judicial review if a regulator fails to comply with policy statements, or does not adhere to long-standing licensing practice.

The concluding remark here is then that 'irrationality' is an umbrella term. In addition to the test of 'reasonable authority', it also covers issues like unreasonable exercise of discretionary power, the taking into account of irrelevant factors, and the failing to consider relevant points.

- Procedural impropriety

This heading is self-explanatory. It covers "failure by an administrative tribunal to observe procedural rules that are expressly laid down in the legislative instrument by which its jurisdiction is conferred, even where such failure does not involve any denial of natural justice."³⁷ Regulatory orders must be made and issued in accordance with

³⁵de Smith, Woolf & Jowell: *Judicial Review of Administrative Action* (1995), Sweet & Maxwell, para. 13-029.

³⁶Highland Regional - case, at 281-E-F.

³⁷C.C.S.U. - case, at 411

procedural rules set forth under the privatisation statutes; should that not be the case interested parties may apply for judicial review.

Procedural impropriety includes both (i) the breach of statutorily required procedures and (ii) the common law rules of natural justice.³⁸ So far as utility regulation is concerned, point (i) is of limited importance: privatisation statutes are reticent about regulatory procedures. Thus natural justice (point (ii) above) is the main ground of challenge.

It should be noted that privatisation statutes do not refer to 'the rules of natural justice'. There is no need for such reference: it is a presumption of English³⁹ law that

. . . when Parliament has conferred a judicial or quasi-judicial power upon a person, he must act in accordance with the rules of natural justice.⁴⁰

Many applicants find this presumption useful: it is not unusual that a regulated utility and/or a customer claim that the regulator breached the rules of natural justice. For example, a decision of the gas regulator was quashed in **R. v. Director General of Gas Supply, ex parte Smith and Another (QBD), LEXIS, 31 July 1989**. The court ruled that the procedure was not fair: Mr. and Mrs. Smith were not invited to make representations in connection with certain information British Gas plc. presented to the DG. Pill J. pointed out that the regulator's discretion as to the procedural rules (s)he follows is not unfettered: there is a "requirement to adhere to rudimentary concept of fairness".

The Court of Appeal reaffirmed the principle that regulators are under a duty to act fairly in Scottish Power. Sir Ralph Gibson granted judicial review arguing that the DG of Electricity Supply should have proposed certain modifications "on the grounds of fairness".

To conclude, the courts are unwilling to quash regulatory decisions on procedural grounds, unless the investigation, inquiry etc. was unfair.

3.3 Available remedies

If, despite the problems highlighted above, an application for judicial review were successful what kind of remedies may be awarded? The most satisfactory solution for the applicant would be if the court were to overrule the regulatory agency. The original decision would be declared null and void. The judgement may also contain a new decision which would be final and binding. In other words, by the end of the judicial review procedure the successful applicant would have a new resolution in hand. The dispute would be over once and for all.

Yet, in practice, judicial review operates along quite different principles in the United Kingdom. As was argued above the judiciary is not enthusiastic about being involved

³⁸de Smith, Woolf and Jowell: *Judicial review of Administrative Action* (1985), Section 15-067.

³⁹There is no reason why the same presumption would not apply in Scotland.

⁴⁰Glanville Williams: *Learning the Law* (1982), page 109.

in administrative decision-making: judges see their role as being a 'football referee' whose task is "to intervene when a breach of the rules has occurred."⁴¹ Football referees do not score goals; judges do not make administrative decisions. It is a fundamental principle of judicial review that the courts do not reconsider the merits of administrative decisions. De Smith states that "the judges ought not to imagine themselves as being in the position of the competent authority". To do so would involve the courts in a process "which is inappropriate to judicial review because it involves the court acting as if they were themselves the recipients of the power."⁴²

The Court of Session came to the same conclusion in **West v. Secretary of State for Scotland 1992 S.L.T. 636**.⁴³ The Court held that

the sole purpose for which the supervisory jurisdiction might be exercised was to ensure that the person or body did not exceed or abuse that jurisdiction, power or authority or fail to do what the jurisdiction, power or authority required.

Lord Hope in his speech underlined that the Court of Session has no jurisdiction to review the judgement of an inferior tribunal on the merits of the question.⁴⁴ His Lordship restated the principles of judicial control as follows:

... where a particular matter has been entrusted to an inferior body or tribunal the Court of Session cannot substitute its own view for what that body or tribunal may decide; but it can nevertheless interfere in order to control any excess or abuse of power or failure to act within the limits of the jurisdiction which has been conferred.⁴⁵

Academic writers also emphasize the limits of judicial review jurisdiction. For example, Stephen Dow points out that

... judicial review does not [...] allow the substantive point to be raised before the court, rather the sole issue is whether the regulator followed appropriate procedure to arrive at his decision.⁴⁶

Similarly, Jeffrey Goh noted in connection with **Highland Regional Council v. British Railways Board 1996 S.L.T. 274**, that

⁴¹E.C.S. Wade and A.W. Bradley: *Constitutional and Administrative Law* (1993), page 671.

⁴²de Smith, Woolf & Jowell: *Judicial Review of Administrative Action* (1995), Section 13-007.

⁴³W.J. Wolfe: *The Scope of Judicial Review in Scots Law*. In: [1992] P.L. 625 - 637.

⁴⁴at page 641 F-G.

⁴⁵at page 644 F.

⁴⁶Stephen R. Dow: *A Survey of Major Development in the Post-privatisation Phase of UK Gas and Electricity Supply Industries* (1996), page 25.

... the substantive merits of a [regulatory] policy should not be a matter for judicial determination.⁴⁷

To conclude, courts do NOT reconsider the merits of administrative decisions challenged. This point determines the scope of available remedies. If judges may not rule on the merits of the administrative decision impugned, the remedy will be either (i) a declaration or (ii) the regulatory order will be quashed.

An additional remedy is available in Scotland (but not in England and Wales). As was explained in Chapter 1. above, privatised utilities are under a statutory duty to supply customers on request. The Court of Session may order the specific performance of a statutory duty: the Lord President ruled so in **T. Docherty Ltd. v. Monifieth Town Council** 1971 S.L.T. 13.⁴⁸ In theory, the Court of Session may order a privatised utility to connect would-be customers to the telecommunication, electricity, gas or water networks. This remedy does not form part of the law of England. Thus the Court of Session has a broader range of remedies than its English counterpart; and this is not the only difference between the two legal systems.

Two further points should be noted here:

(i) 'Public - Private' divide

Judicial review is a **public law** remedy in England: private law matters are NOT subject to judicial review. The 'public - private' divide may give rise to difficulties. There is little doubt that (i) a dispute between soldiers and the Ministry of Defense would satisfy the 'public law matter' - test (**R. v. Ministry of Defence, ex parte Smith and other applications** [1995] 4 All ER 427); while (ii) there is no public law element if a husband is quarrelling with his wife. Yet drawing the line between 'public' and 'private' is not always easy. For example, the High Court of England and Wales may refuse to get involved in disputes concerning the decisions of religious bodies.

As will be mentioned under point (ii) below, the Court of Session may review the decisions of church courts and office-bearers. The question whether the power of review extends to a particular claim is NOT decided by reference to the 'Public - Private' divide in Scotland: as John St. Clair and Neil Davidson underline, "... the Scottish remedies are competent against any respondent".⁴⁹ Hence applications that would not satisfy the 'public law matter' - test in London will not be refused in Edinburgh.

⁴⁷Jeffrey Goh: *Have Sleep Will Travel* In: [1995] 6 Util LR 148.

⁴⁸ See also: Tom Mullen: *Introduction to Scottish Judicial Review* In: [1996] JR 107., at 109. and *Stair Memorial Encyclopaedia*, volume 1., paras 302. and 335.

⁴⁹John St. Clair and Neil F. Davidson: *Judicial Review in Scotland* (1986), point 3.16.

(ii) Jurisdiction

It follows from the fact that the 'Public - Private' divide does not apply in Scotland that more claims are subject to judicial review under Scots law. Two examples may be mentioned here:

- the behaviour of arbitrators is susceptible to judicial review in Scotland⁵⁰; and
- the Court of Session is willing to review the operation of church courts⁵¹.

One may conclude then that, compared to England, Scotland may be a better place to challenge regulatory decisions. Judicial review is NOT a public law remedy in Scotland, therefore

the Court of Session (1) may order the specific performance of a statutory duty (T. Docherty - case); and (2) may review certain claims which would not be susceptible to judicial review under the law of England (e.g. religious bodies and behaviour of arbitrators).

Is there a paradox here ? Scotland seems to be a better place to challenge regulatory decisions; yet all the cases to be discussed below were proceedings in the High Court of England and Wales. Why did not potential applicants turn to the Court of Session for help ? Why was Scottish Power plc. advised to bring proceedings in England (**R. v. Director General of Electricity Supply, ex parte Scottish Power plc. (C.A.)**, LEXIS, 3 February 1997) ?

The answer may be found in **Bank of Scotland v. Investment Management Regulatory Organisation Ltd. (Ex. Div.) 1989 S.L.T. 432**. The main points of this case may be summarised as follows:

- the Bank of Scotland [hereinafter; the Bank] presented a petition for judicial review of certain decisions of IMRO, a self-regulating body;
- the Bank contended that the Court of Session had jurisdiction to entertain the said petition under Rule 2(2) of Schedule 8 to the Civil Jurisdiction and Judgements Act 1982; and
- IMRO argued that the application was incompetent: the Court of Session had no jurisdiction because IMRO's registered office was in London.

The Extra Division of the Court of Session ruled that "The bank has instituted these proceedings in the wrong part of the United Kingdom."⁵² The Court held that "... Rule 2(2) does not apply to found jurisdiction by Scottish courts, ...".⁵³ As Lord

⁵⁰Ibid, 3.20.

⁵¹Ibid, point 3.18.

⁵²Lord Dunpark, at 442-L.

⁵³Lord Dunpark, at 442-K.

Maxwell underlined, Rule 1. of Schedule 8. to the Civil Jurisdiction and Judgements Act 1982 was applicable:

1. Subject to the following rules, persons shall be sued in the courts for the place where they are domiciled.

His Lordship found that (i) IMRO was the 'defender' and (ii) the seat of a corporation was its 'domicile'⁵⁴, therefore the Court of Session had NO jurisdiction.

The Bank of Scotland - case is an important warning: an application seeking to challenge decisions of a London-based regulatory office may be refused in Scotland on jurisdictional grounds. As a matter of fact, all the single-industry regulatory offices are based in London; hence the rule in Bank of Scotland may not be ignored in seeking jurisdiction. This is why potential applicants seem to prefer the High Court of England and Wales to the Court of Session. Thus the discussion below will concentrate on the *English* procedure; nevertheless references will be made to the appropriate Scottish terminology.

A./ Declaration (in Scotland: Declarator⁵⁵)

The action for declaration is one of the most popular forms of proceedings in the High Court today.⁵⁶ If intervention in the administrative decision making is necessary, declaration appears to be the preferred technique.⁵⁷ The Director General of OFFER told the Trade and Industry Committee that disappointed licensees should apply for "a declaration in ordinary proceedings."⁵⁸ This advice is correct: the vast majority of legal disputes between regulators and regulated are concerned with the meaning of statutes, contracts, licences, etc. The courts are the best qualified forum for interpreting Acts of Parliament and legal documents. A party dissatisfied with the interpretation of a regulatory agency might expect definite and final interpretation from the judiciary.

A Declaration was sought in **Regina v. Director General of Gas Supply, ex parte Smith (Q.B.), LEXIS, 31 July 1989** as to the powers and duties of British Gas plc. under paragraphs 1, 4 and 10 of Schedule 5 to the Gas Act 1986. **Mercury Communications Ltd. v. Director General of Telecommunications and another (H.L.) [1996] 1 All ER 575** is another example. The Director General of OFTEL interpreted certain terms ('fully allocated costs' and 'relevant overheads') in a way which was not to the advantage of Mercury. Mercury challenged the validity of the

⁵⁴ Lord Maxwell, at 445-L.

⁵⁵ John St. Clair and Neil F. Davidson: *Judicial Review in Scotland* (1986), point 4.06.

⁵⁶ de Smith, Woolf & Jowell: *Judicial Review of Administrative Action* (1995), Section 14-066.

⁵⁷ See comments by Sir John Donaldson, MR, in **R. v. Take-over Panel, ex parte Datafin plc. [1987] 1 All ER 564, CA**, at 579-J.

⁵⁸ House of Commons: Trade and Industry Committee: *Energy Regulation HC 50-vii 1996-97*, page 187.

Director General's interpretation. As the Chief Executive Officer of Mercury summarised in the press, all Mercury wanted was

. . . an independent interpretation of the correct basis on which the Director General of OFTEL must now set interconnect charges payable by Mercury to BT.⁵⁹

The interesting point about the Mercury - case is that Mercury issued an originating summons; they were not applying for judicial review. The Court of Appeal ruled that Mercury was wrong: judicial review would have been the proper form of action.⁶⁰ Yet the House of Lords overruled the Court of Appeal in the case quoted above. Hence judicial review is not the sole dispute resolution technique in the regulatory game: ordinary 'private' litigation may be initiated under certain circumstances.

Why did Mercury prefer originating summons to judicial review? One of the potential reasons is that a Declaration as to the meaning of the two terms in dispute would not have been good enough for the telecom company. After a successful judicial review Mercury should have gone back to the Director General with a request to reconsider his interpretation in the light of the judgement. A Declaration from the court could not have solved the problem; it would have been a step towards finding a solution. By contrast, proceeding with originating summons may resolve the dispute at once: as Lord Slynn commented in the House of Lords

The court has jurisdiction to interpret the words at issue, [. . .], then the contractual obligation undertaken must be, if the interpretation of these words is referred to the court, that which the court decides.⁶¹

Thus Mercury might not have to go back to the Director General; the court would fix the terms and conditions of the contractual obligation undertaken. This outcome is of more practical use than a Declaration; perhaps this is why Mercury preferred originating summons to judicial review.

To conclude, a declaration does not end a dispute between regulators and regulated. The court pronounces the final and definitive interpretation, but leaves it to the regulator to redraft the order challenged in the light of the judgement.

⁵⁹The Financial Times, 1 March 1994.

⁶⁰The Financial Times, 23 July 1994.

⁶¹Mercury - case, at 583 - H.

B./ Application to quash

Two comparative law points should be made here:

- (i) English - Scots terminology:
'Application to quash' *versus* 'Petition for reduction'.

The term 'Application to quash' is not in use in Scotland. The equivalent in Scots law is 'Petition for reduction': if judicial review is granted then the administrative order will be quashed by a 'decree of reduction'.⁶² So far as the end-result is concerned, there is no difference between the two legal systems: the administrative decision impugned will be quashed.

- (ii) English - Continental systems:
Judicial review: whether appeal or not.

The setting aside of a decision of an inferior administrative tribunal is not an appeal in the UK.⁶³ By contrast, the setting aside of decisions is the principal form of appeal in France and in Italy. As Zweigert and Kötz note, the French Court of Cassation and the Italian Corte di Cassazione quash decisions of the inferior courts.⁶⁴ Hence judicial review is an appellate jurisdiction on the Continent, while it is not classified as an appeal in Britain. It is of special importance whether judicial review is seen as an appeal or not:

If judicial review is an APPEAL, then
the court may substitute its decision for the administrative resolution.⁶⁵ See the French and Italian examples.

If judicial review is NOT an APPEAL, then
the court may not consider substantive points. If an application is successful, then the order challenged is set aside: it is for the administrative body to make a new resolution. This is the situation in the UK.

Yet this theoretical distinction may not hold sway if the quashing of the original resolution points directly to the only legally acceptable interpretation. This is the case when the merit of an administrative decision may be expressed as a YES - NO binary

⁶²For example, *Watt v. Lord Advocate*, 1977 S.L.T. 130 (O.H.).

⁶³Denning LJ in *R. v. Northumberland Compensation Tribunal*, ex parte Shaw [1952] 1 KB 338, at 347 (English view) and Lord Hope in *West v. Secretary of State for Scotland* 1992 SLT 636, at 641-F-G (Scottish view)

⁶⁴Zweigert and Kötz: *Introduction to Comparative Law* (1992), page 124. And see also: Peter De Cruz: *Comparative Law in a Changing World* (1995), page 107.

⁶⁵Peter Cane: *An Introduction to Administrative Law* (Clarendon Press, 1996), page 8.

code (see point 3.9.2. below). For example, an administrative body refused to issue a licence to perform in **Gerry Cottle's Circus Ltd. v. Edinburgh District Council** 1990 S.L.T. 235 (no licence - i.e. NO - choice). The circus applied for judicial review. The resolution of the council was quashed leaving the council no option but to issue the licence to perform (if not NO, then YES - choice - i.e. licence shall be issued).

A further example is **Air 2000 v. Secretary of State for Transport (O.H.)** 1989 S.L.T. 698. In this case the court ruled that Section 3. of the Traffic Distribution Rules 1986 was ultra vires and invalid. The said section forced transatlantic flights from Glasgow and from Edinburgh to stop at Prestwick Airport. The decree of reduction deleted Prestwick Airport from Section 3. of the Traffic Distribution Rules 1986; hence Air 2000 could fly directly from Scotland to the USA. No other interpretation of the said Rules was legally possible.

The test of 'only one decision' is not unknown in the utilities sector: it was applied in **R. v. Director General of Electricity Supply, ex parte Scottish Power plc. (C.A.)**, LEXIS, 3 February 1997. The electricity company asked the court, among others, to propose specific licence modifications; yet Sir Ralph Gibson refused to do so arguing that

The Court should not, in our judgement, make such an order unless it is clear that at the time of making the invalid decision, there was only one decision which the Director, in the proper performance of his duties, and on the material before him, could reasonably make.⁶⁶

To conclude, the quashing of the original resolution may be as good as a new resolution from the regulator PROVIDED that

- (i) there are two legally possible solutions only (YES - No choice - e.g. either a licence is issued or not), and
- (ii) the court declares the original decision of the administrative body invalid (Gerry Cottle's Circus and Air 2000), then
- (iii) there is only one legally acceptable solution (i.e. if the original decision was NO, then YES, and *vice versa*).

Privatisation acts expressly empowered the courts to quash an order or any provision of an order challenged in judicial review.⁶⁷ If application to quash is successful the court may rule that (i) the original decision must be set aside and (ii) the regulator should re-hear the case. **R. v. Director General of Electricity Supply, ex parte Redrow Homes (Northern) Ltd. (QBD)**, LEXIS, 3 February 1995. is an example. The Director General of OFFER advised the construction company that he had no power to determine the reasonableness of connection charges once those charges had been paid. Redrow Homes applied for judicial review arguing that this interpretation

⁶⁶Lexis, 3 February 1997.

⁶⁷See, for example, Section 27(2) of the Electricity Act 1989.

was not correct. Mr. Justice Schiemann ruled that if a dispute was referred to the Director General he had to deal with it.⁶⁸ Had Mr. Justice Schiemann not adhered to the purely supervisory theory of judicial review (see above), he could have determined whether the connection charge was reasonable. But he quashed the resolution of the Director General and referred the dispute back to OFFER. Similarly, the court remitted the case to the Director General of OFFER in Scottish Power mentioned above; the Director General was ordered to examine the case and

... to reach a decision in accordance with the findings of this Court, including consideration of whether to make a further reference to MMC.

The point here is that the order of certiorari to quash does not end the dispute between regulators and regulated. As a rule, it is for the regulatory office to reconsider the case and to make a new resolution.

To conclude, the two remedies discussed above do not end the dispute between regulators and regulated. Neither (A) a declaration nor (B) the setting aside of the original resolution will extinguish the dispute between regulators and regulated. What the regulated company seeks is a new resolution which will come, as a main rule, from the regulator and not from the court. Thus ordinary remedies from the courts do not satisfy the practical needs of regulated utilities: this is one of the reasons why privatised companies do not apply more frequently for judicial review.

3.4 The making of a new regulatory decision

It was argued above that the court will not reconsider the merit of a regulatory order: it is for the regulator to make a new decision. The practical problem here is that the post-privatisation regulatory regime in Britain is personalised.

The Directors General are personally responsible for the regulation of gas, electricity, water, and telecommunication industries. The personality of the Directors General does influence the style of regulation and the co-operation between regulators and regulated utilities. John Ernst makes the point that

... the British model of regulation differs most notably from its American progenitor in its reliance on, what could reasonably be described as, 'personality-led regulation'. In other words, much of the focus, and certainly the character of the public bodies set up to regulate the privatised utilities in Britain, imitate the persona of their respective directors.⁶⁹

⁶⁸The Times, February 21, 1995.

⁶⁹John Ernst: *Whose Utility* (1994), page 63.

The story of the two Directors General of OFGAS illustrates this point. After fierce confrontations in the press, working relations between the gas company and Sir James McKinnon broke down; the latter had to step down eventually. The incoming Director General of OFGAS, Ms. Clare Spottiswoode, went out of her way to improve the day-to-day relationship with British Gas plc.⁷⁰

Privatisation legislation made a major contribution to the emergence of personalised regulation in Britain. Privatisation statutes, following the pattern of the Fair Trading Act 1973, recognise the Directors General as officers in charge of the regulation of utility industries. Yet the legislation does not refer to regulatory offices. Hence there were some uncertainties as to the constitutional standing of OFGAS, OFWAT, OFFER, and OFTEL. Some commentators argued that the single-industry regulatory offices are government agencies, while others classify them as ordinary departments of government.⁷¹ The most satisfactory classification of the single industry regulatory offices would be to label them as non-ministerial government departments.⁷²

Being agencies of the Crown provisions of the Crown Proceedings Act 1947 are applicable to these offices. Section 17 provides that proceedings against the Crown shall be instituted against the appropriate authorised department. The list of authorised departments is annexed to the Act; it includes the Directors General⁷³. Thus the proper respondent in a judicial review procedure is the competent Director; service is to be made on The Treasury Solicitor. This arrangement further emphasises the personalised character of regulation in Britain: regulatory offices have no legal standing in the UK.

A House of Commons publication summarised the standing of the single-industry regulatory offices as follows:

The Acts of Parliament which carried out the privatisation and established the powers of the regulatory agencies lay the various duties upon the Directors of the various industries and not upon the regulatory agencies as corporate bodies. Each agency is there to assist the Director and not legally to share in the decision-making process.⁷⁴

⁷⁰For example, OFGAS accepted a recommendation by MMC that the efficiency factor in the formula be relaxed to - 4 from the original - 5. *The Financial Times*, 28 January 1994.

⁷¹Cento Veljanovski: *The Regulation Game*, In: Cento Veljanovski (ed): *Regulators and the Market* (1991). In connection with the status of OFT, see: Brian W. Harvey: *The Law of Consumer Protection and Fair Trading* (1982), page 268.

⁷²Fiona Poole suggests the same classification in connection with the status of OPRAF. Fiona Poole: *Rail Privatisation: a Progress Report* (1995), page 18.

⁷³For example, *The Supreme Court Practice* (1995), Volume 2., para. 6038.

⁷⁴House of Commons Library Research Division. *Background Paper: The Regulation of Privatised Utility Companies* (1991) page 1.

The Directors General personally are sued in judicial review.⁷⁵ Furthermore, Directors, and not offices, may bring proceedings against a licensee: Section 30(8) of the Gas Act 1986 provides that the Director General of OFGAS may apply to the court for "an injunction or interdict or any other appropriate relief."

The personal involvement of the Directors General may be a source of practical concerns. It was mentioned above that if a regulated utility does not agree with the regulator on a proposed licence modification the dispute is referred to the MMC. Two problems may arise here:

- (i) It is the Director General who frames the reference to the Commission; she/he may also vary a reference

by adding to the matters specified in the reference or by excluding from the reference some or all of the matter so specified.⁷⁶

It should be underlined that regulated utilities do not have a word in the drafting of monopoly references. As Dr. Kim Howells MP noted ". . . this is not necessarily conducive to the spread of universal happiness."⁷⁷

- (ii) After a successful judicial review, the matter complained of would be returned to the regulator for further consideration (see Scottish Power - case above).

As a matter of fact, a single Director General is in charge of each office: thus the same officer who framed the MMC reference and signed the original resolution will have the final word again. The regulated company will be in an awkward position: the same decision is to be re-discussed with the same regulator. What is the likelihood that the same Director General would come to a different conclusion? Will (s)he take a fresh approach?

With all respect for the outstanding professional and personal capabilities of the Directors General, it is to be noted that seeking a new decision from the same decision maker is not an easy task. Different legal systems offer different solutions to this problem. In France, for example, if a judgement is quashed, the Court of Cassation will remit a case to a different inferior court.⁷⁸ In Hungary, the same dispute may go back to the same county court in civil litigation; but not before the

⁷⁵For example: *Regina v. Director General of Electricity Supply, Ex parte Redrow Homes (Northern) Ltd.* The Times, February 21, 1995; or the Scottish Power - case.

⁷⁶See, for example, Section 24(1) - (2) of the Gas Act 1986.

⁷⁷Dr. Kim Howell MP: *Approaching Regulation from Westminster* (1996), page 9.

⁷⁸Konrad Zweigert and Hein Kötz: *Introduction to Comparative Law* (1992), page 124.

same panel of judges.⁷⁹ As far as regulatory decisions are concerned, no similar safeguards exist in the UK: the same Director General will deal with the matter if the original order is quashed in a judicial review procedure.

A particularly interesting question is whether a Director General may be removed from office in the course of a judicial review procedure. What would happen if a privatised utility were to prove that a Director General does not have an open mind to rethink the problem? For example, Lord Slynn noted in **Mercury Communications Ltd. v. Director General of Telecommunications and another (HL)** [1996] 1 All ER 575 that the Director General of OFTEL stands by his original interpretation.⁸⁰ In the law of arbitration, an arbitrator may be removed provided that she/he made up her/his mind and would be unable to decide otherwise. Is the same remedy available in judicial review? The court may not remove Directors General: it is the Secretary of State who may dismiss a Director from office "on the ground of incapacity or misbehaviour".⁸¹ It is unlikely that adherence to an interpretation would fall under any of these categories. As Aileen McHarg remarks,

The chances of a regulator ever being dismissed must be very slim, though pressure to resign or failure to reappoint are perhaps more likely.⁸²

What solutions are available then? Some regulated companies suggest that Directors General should be replaced with a tribunal of between three and five members, along with the creation of a single joint utilities regulator.⁸³ Academic commentators made the same recommendation.⁸⁴ The idea of a regulatory panel was welcome by the Labour Party. Although not in a definite form, this party promised that individual regulators will be replaced with a panel of regulators under a Labour government.⁸⁵ A joint study by the Centre for the Study of Regulated Industries and Price Waterhouse concludes that the idea of regulatory panels should be considered.⁸⁶

⁷⁹Polgári Perrendtartás (Act III. of 1952).

⁸⁰*Mercury* - case, at 583-E.

⁸¹For example, Section 1(3) of the Gas Act 1986.

⁸²Aileen McHarg: Accountability in the Electricity Supply Industry In: [1995] 6 Util LR 42, footnote 16.

⁸³The Financial Times, 15 April 1994.

⁸⁴Alex Henney: A Study of the Privatisation of the Electricity Supply Industry in England and Wales (1994), page 326. Stephen R. Dow: A Survey of Major Developments in the Post-privatisation Phase of UK Gas and Electricity Supply Industries (1996), page 66.

⁸⁵The Financial Times, 17 May 1995.

⁸⁶Centre for the Study of Regulated Industries & Price Waterhouse: Regulated Industries: The UK Framework (1996), page 14., point 2.4.1.

Yet not all commentators are enthusiastic about the setting up of panels. The Memorandum submitted by the Public Utility Reform Group to the Trade and Industry Committee states that

The formal organisation of a 'panel' system of management of regulatory function would not by itself guarantee what is most required.⁸⁷

The Director General of OFGAS also told the Committee that "A panel may not be as responsive and flexible as a single Director General."⁸⁸ Professor Cosmo Graham warned against the establishment of a regulatory panel:

Panel decision taking will inevitably tend towards a greater degree of compromise and consensus than decisions by a single individual. This may not mean better decision making. The record of equivalent bodies in the UK is mixed.⁸⁹

John Kay agrees. He claims that the practical difference between regulation by board, like in the financial services, or by a single regulator is negligible. He makes the following comments:

This personalisation of regulation is itself another subject of, largely unjustified, criticism. If able people are to be attracted to regulatory positions, it is likely that they will become well-known public figures, if they are not already; . . . The greater danger by far is that the functions are performed by nonentities. Securing staff of appropriate calibre for regulatory agencies is already a serious problem.⁹⁰

The argument presented by John Kay is correct to this extent: personalisation is not a problem if and when the regulatory regime works smoothly. Yet as soon as utilities or customers seek help from the courts, 'personalisation' may create practical difficulties. A Director General might face some professional and, perhaps, personal dilemma when she/he is required to reconsider her/his previous decisions.

To conclude, the setting up of a joint regulatory panel, or single industry panels would reduce the personalised character of regulation in Britain. It was argued above that personalisation is a problem if the court quashes a regulatory order but the Director General has fixed her/his mind. This problem may not occur if regulatory panels were in place. Hence the application to quash a regulatory order might be a more popular

⁸⁷House of Commons: Trade and Industry Committee: Energy Regulation HC 1996-97 50-v, page 150, point 11.

⁸⁸op. cit., HC 50-viii, page 247., Q.5.

⁸⁹op. cit., 50-II, page 121, point 11.

⁹⁰John Kay: The Future of UK Utility Regulation. In: Professor M. E. Beesley (ed): Regulating Utilities: A Time for Change ? (1996), pages 152 - 153.

action if regulatory panels (as opposed to Directors) were in charge of utility regulation in Britain.

The main points on the general law on judicial review may be summarised as follows. As a rule, the prospects for potential applicants are gloomy: (i) the judiciary does not want to be involved in the administrative decision making process; (ii) available remedies will not satisfy the practical needs of privatised companies; and (iii) after a successful challenge the same regulator is supposed to issue a new order. Compared with the general law on judicial review, are the privatised utilities in a better position under the privatisation Acts ?

Part II.

Judicial Review in the Utilities Sector

Having analysed the general law on judicial review, it is appropriate to turn to the utility legislation. Two issues should be discussed here: (i) Who may seek judicial review under the privatisation Acts ?; (ii) What procedural regimes govern the judicial review of regulatory decisions ?

3.5 Standing to apply for judicial review

Privatisation Acts expressly authorise regulated utilities to question the validity of regulatory orders on grounds to be discussed under point (ii) below.⁹¹ The question here is whether a third party having the necessary *locus standi* may seek judicial review. A theoretical example here would be as follow:

A gas distribution licence contains two annexes: Annex A lists settlements which are connected to the gas distribution network; Annex B lists settlements which shall be connected by 19X8. Under the Gas Act 1986 the distribution company and the regulator may modify the gas distribution licence by an agreement: at the request of the licensee, OFGAS deletes Nowhere Town from Annex B in 19X7. After this modification the supplier will no longer be obliged to get this settlement connected to the distribution network. The local council of Nowhere Town wants to block the coming into force of that modification. Could the local council initiate proceedings ?

Under the Gas Act 1986 the modification of licences by agreement is a deal between the office and the licence holder. But the legislation also provides that before the competent Director General makes modifications, a notice should be given specifying the period within which representations and objections may be presented.⁹² The Directors General are explicitly required to bring the notice to "the attention of

⁹¹For example, Section 30 of the Gas Act 1986.

⁹²See, for example, Section 11 of the Electricity Act 1989

persons likely to be affected by the making of the modification."⁹³ As a general practice, notices are published in the national and the local newspapers.

Thus the local council may make objections to the Directors General who will be obliged to consider such representations and objections.⁹⁴ Should the Directors General go ahead with the modification ignoring objections made the local council could apply for judicial review. De Smith's Judicial Review of Administrative Action points out that:

... if the statute gives the applicant the right to make representations before the decision is reached this will be a strong indication that he has standing to challenge the decision when it is made.⁹⁵

In addition, the local council in the example above may also have title to sue under the rule in **Gordon v. Kirkcaldy District Council 1989 S.L.T. 507**. The main points of this case may be summarised as follows:

A local council had been collecting waste free of charge directly from caravans in a caravan park. Subsequently the council decided to collect waste only from the site as a whole and to charge the operator of the site for collecting. It goes without saying that caravan owners were unhappy with the new practice of the local council; two of them appealed to the Court of Session.

One of the preliminary questions before the court was whether tenants of two caravan pitches had title and interest to bring a petition. Counsel for the respondents submitted that they had none: the administrative decision issued by the local council was addressed to the site operator and not to the tenants of the site. Counsel for the petitioners averred that they had title by reason of being rate payers and also producers of domestic waste. Lord Cullen ruled that the petitioners had title and interest to sue "in order to have that decision set aside".⁹⁶

As far as modification by agreement is concerned, the local council of Nowhere Town is in the same position as tenants of the caravan sites were in Gordon. The local council is not a party to the administrative decision complained of (i.e. the agreement between the regulator and the gas supplier), nevertheless it has title and interest to sue in order to block the proposed licence modification.

To conclude, third parties likely to be affected by a decision of the regulator may challenge the validity of a proposed licence modification. It is settled law that persons who are entitled to make representations before a decision is reached may apply for

⁹³See, for example, Section 11(3)(a) of the Electricity Act 1989

⁹⁴See, for example, Section 11(2) of the Electricity Act 1989

⁹⁵De Smith, Woolf & Jowell: Judicial Review of Administrative Action (1995), Section 2-024

⁹⁶at 513 - L

judicial review. For example, a regular swimmer had standing to sue in connection with the discharge of sewage to the sea in **Regina v. National Rivers Authority, ex parte Moreton**, LEXIS, 13 September 1995.

Modification by agreement is subject to the same rules. Hence third parties may bring proceedings even though the regulator and the regulated company agreed on a particular licence modification. The Trade and Industry Committee came to the same conclusion in a report on energy regulation: according to the Committee, "judicial review of regulatory decisions may be applied for by any interested party . . .".⁹⁷

3.6 Judicial Review Procedures

One of two procedural regimes shall be used if a potential applicant intends to challenge the validity of a regulatory decision: /A/ Statutory Application to Quash and /B/ 'ordinary' Common Law judicial review. As a main rule, the vast majority of applicants will proceed under point /B/; statutory application to quash is only applicable if so-called 'final' or 'provisional' orders are impugned. What kind of orders are these ?

/A/ Statutory Application to Quash Final or Provisional Orders

The Directors General may issue final or provisional orders if a licensee "is contravening, or has contravened and is likely again to contravene, any relevant condition or requirement"⁹⁸. A final or provisional order may require a licensee "to do, or not to do, such things as are specified in the order or are of a description so specified"⁹⁹. The enforcement of licence conditions is the main point here: the regulator will issue final or provisional orders if a licensee does not toe the line. It is unlikely that many such orders will be made. As was discussed in Chapter 1., utility regulation is a 'negotiated process' in Britain: regulators and regulated utilities tend to settle disputes informally. One would suppose that the two parties will reach an agreement before the regulator were to issue a final or provisional order. It is no surprise then that no application seeking to impugn a final or provisional order has been reported until today.

Should a licensee intend to challenge such orders in the future, the following points would be relevant:

⁹⁷House of Commons: Trade and Industry Committee: Energy Regulation HC 1996-97 50-I, page lix, point 169.

⁹⁸Section 28(1) of the Gas Act 1986.

⁹⁹Section 28(7)(a) of the Gas Act 1986.

- I. **Grounds:** the validity of orders may be questioned on two grounds: (i) Powers - the regulator had no power to make the decision impugned; or (ii) Procedure - procedural requirements of the privatisation Acts were not complied with;
- II. **Time Limit:** the period within which applications for judicial review shall be made is 42 days; and
- III. **Ouster Clause:** the validity of a final or provisional order "may not be questioned by any legal proceedings whatever", save as provided in the relevant privatisation Act.

Points I. - III. set forth standard conditions: the same grounds, time limit, and ouster clause may be found in a number of statutes, especially in the fields of compulsory purchase and land use planning¹⁰⁰. Three notes should be made here:

(i) Grounds

Although the privatisation Acts refer to grounds (a) and (b) only, there is little doubt that applicants are in the same position as if they would seek judicial review under R.S.C. Ord. 53 (to be discussed below). All the traditional grounds (see point 3.2 above) are available to impugn the validity of final or provisional orders. As de Smith notes, " . . . , the language of judicial review is sometimes employed to assess the validity of decisions challenged under statutory review [i.e. Statutory Application to Quash]."¹⁰¹

(ii) Time limit

Compared to ordinary 'Common Law' judicial review procedures, the time limit is (a) shorter and (b) stricter in the case of Statutory Application to Quash.

As to (a) -

Proceedings must be made within 42 days "from the date of service on him of a copy of the order"¹⁰². Applicants have only half the ordinary time limit (three months) to turn to the court for help. Sir Thomas Bingham MR underlined in Save Our Railways that applicants should "take action with the utmost promptness."

¹⁰⁰de Smith, Woolf and Jowell: *Judicial Review of Administrative Action* (1995), Sections 14-072 and 15-065.

¹⁰¹de Smith, Woolf and Jowell: *op. cit.*, Section 15-066.

¹⁰²Section 30(1) of the Gas Act 1986.

As to (b) -

Once this period has expired judicial review is deemed to be precluded¹⁰³; the court has "no discretion to extend" this time period.¹⁰⁴

(ii) Scope of remedies

This issue has been discussed under point 3.3 above and will be analysed further under 3.9.2(ii) below. Suffice it to say here that, compared to 'ordinary' judicial review procedures, the remedial powers of the court are limited.¹⁰⁵ As a rule, two kinds of remedies may be granted: the order complained of may be (a) quashed; or (b) quashed and remitted back to the decision-maker for reconsideration¹⁰⁶. So far as the utilities sector is concerned, there is no practical difference between remedies (a) and (b). If a final or provisional order is quashed, the issue will be remitted to the Director General: as was noted under 3.4 above, only the head of the regulatory offices may issue a new order.

/B/ R.S.C., Order 53 - procedure

This is the 'ordinary', Common Law judicial review procedure in England and Wales. The procedural rules are set forth under Order 53. of the Rules of the Supreme Court [hereinafter: R.S.C.].¹⁰⁷ This is the main procedural regime to challenge regulatory orders. The point to be stressed here is that none of the restrictions mentioned under point /A/ above are applicable here.

- Unlike in the case of the Statutory Application to Quash procedure, the kind of orders susceptible to review is NOT defined here. Utilities and third parties seek judicial review under R.S.C. Ord. 53. to impugn a wide variety of regulatory decisions. The applicants argued in **R. v. Director General of Electricity Supply, ex parte Scottish Power (CA)**, LEXIS, 3 February 1997 that the regulator attached importance to a fact of no significant force; in **R. v. Director of Passenger Rail Franchising, ex parte Save Our Railways and Others (CA)**, LEXIS, 15 December 1996 that the Director did not comply with a ministerial direction; in **In the Matter of Applications by Sherlock and Morris for Judicial Review (QBD)**, LEXIS, 29 November 1996 that Northern Ireland Electricity did not consider the personal circumstances of the applicants; in **R. v. Director General of Electricity Supply, ex parte Redrow**

¹⁰³Michael Fordham: Judicial Review Handbook (1997), para 28.2.

¹⁰⁴de Smith, Woolf and Jowell: op.cit., Section 15-061.

¹⁰⁵Ibid., Section 15-063.

¹⁰⁶"Remission with a direction to consider" - Richard Clayton and Hugh Tomlinson: Judicial Review Procedure (1997), para 3.2.3.

¹⁰⁷It was Section 31 of the Supreme Court Act 1981 which gave a statutory basis to Ord. 53. - de Smith, Woolf and Jowell: op. cit., Section 15-011.

Homes (Northern) Ltd. (QBD), LEXIS 3 February 1995 that the refusal to determine a dispute was based upon a misconstruction of statutory provisions; and so on. The point here is that any regulatory decision may be challenged under R.S.C. Ord. 53., save final or provisional orders.¹⁰⁸

- The remedial powers of the court are not restricted to certiorari in the case of R.S.C. Ord. 53. applications. In theory, mandamus, prohibition, declaration, etc. may be issued: in practice, the court tends to grant certiorari only. The reason for this will be discussed under point 3.9.2 below.

The diagrammatic presentation of the above discussion would be as follows:

	Statutory Application to Quash	R.S.C. Ord. 53
Grounds	illegality, irrationality, and procedural impropriety	illegality, irrationality, and procedural impropriety
Time limit	42 days	3 months
Remedies	certiorari or remission with a direction to consider	certiorari, mandamus, prohibition, declaration, etc. ¹⁰⁹

TABLE 6.: Judicial Review Procedures Compared

To summarise: (i) two procedural regimes are available to challenge the validity of regulatory orders; (ii) Statutory Application to Quash - rules apply if final or provisional orders are reviewed; (iii) R.S.C. Ord. 53. shall be followed in the case of other applications.

Part III.

The Economic Analysis of Judicial Review¹¹⁰

Economics and law interact in every regulatory decision. If economics and law are so closely connected here, the economic analysis of law might help to understand how the courts actually review regulatory orders.

The economic analysis of law is originally an American idea. The starting point for this school of legal studies was a very simple observation: the fundamental logic of Common law may be economics. Jürgen Mackhaus summarised the basic principles as follows:

¹⁰⁸As was discussed above, Statutory Application to Quash is the proper form of action in the case of final or provisional orders.

¹⁰⁹See: point 3.9.2 below.

¹¹⁰A version of this part of the thesis has been published in: Util. Law Rev., 9(1) Jan - Feb 1998, pages 5 - 9. See Appendix 2.

. . . the Common law evolves toward efficiency; the implication being that statute law does not. . . inefficient law creates large transactions costs; hence parties gain from having inefficient legal arrangement removed. It follows that inefficient legal rules will be litigated again and again, until they approach efficiency. . . . We should therefore observe a tendency toward efficiency in judicial rule making, independent of the particular legal culture in which a judge opines.¹¹¹

The operation of certain legal institutions may be remarkably well described with the help of economic principles. For example, tort, contract, and competition law¹¹² may be analysed by reference to principles such as (i) the inverse relationship between price and output, (ii) opportunity cost, and (iii) the tendency of resources to gravitate from lower valued to higher valued uses if voluntary exchange is permitted.¹¹³ The economic analysis of law became one of the fastest growing legal subjects in the USA in the 1970s. Some leading figures of this law school were promoted to judiciary posts in the 1980s.¹¹⁴ In contrast, the economic analysis of law was not able to take root for decades in the UK. The subject was "all but ignored".¹¹⁵ The emergence of post-privatisation regulation might direct the attention of British scholars and business(wo)men towards the economic analysis of law. In his classic treatise on the subject, *The Economic Analysis of Law*, Professor (later Judge) Posner dedicates a full chapter to economic regulation. He argues that public utility regulation is the law's answer to the problem of natural monopoly.¹¹⁶ Posner points out that public utility regulation is a product, "much like other products except supplied by the government".¹¹⁷

This 'product' is equally available to both the regulators and the regulated companies at a certain cost. The Economic Analysis of Judicial Review intends to find out why (i) certain potential 'customers' opt for this 'product', while (ii) others decide not to pay for judicial review.

The discussion below will cover this very tiny area of the economic analysis of law. It will be argued that judicial review is not the most efficient method of dispute resolution between regulators and regulated companies. Judicial review does not produce the best allocation of resources. Thus the number of litigations concerning regulatory decisions may not increase further in the UK.

¹¹¹Jürgen Backhaus: Efficient Statute Law. In: Essays in Law and Economics, edited by: Michael Faure, Roger Van den Bergh (1989), page 23.

¹¹²Cento Veljanovski: The Economics of Law (1990), page 15.

¹¹³Richard A. Posner: The Economic Analysis of Law (1972), page 5.

¹¹⁴Cento Veljanovski: op. cit., page 26.

¹¹⁵Cento Veljanovski: op. cit., page 25.

¹¹⁶Richard A. Posner: op. cit., page 141.

¹¹⁷Richard A. Posner: op. cit., page 153.

As was mentioned above, judicial review of regulatory decisions was relatively rare until the early 1990s. For example, the Director General of OFFER was sued on three occasions only between 1989 and 1997.¹¹⁸ There has been an upsurge in judicial review cases since 1993. The question now is whether the number of applications will increase further. It may be useful then to discuss what points applicants are likely to consider before turning to the courts for help. Potential applicants are expected to challenge the validity of regulatory orders if certain conditions are fulfilled: it will be argued below that a simple, perhaps oversimplified, mathematical formula may summarise such conditions. The main points here will be that (i) potential applicants may be divided into two groups; (ii) Licensees and Customers have different incentives to seek judicial review; and (iii) the latter may find it easier to appeal to the courts for the time being.

3.7 Introduction

It has been long recognised that there is an economic dimension to making applications for judicial review. As a rule, practitioners are cost conscious when contemplating an application for judicial review; and they frequently weight up the pros- and cons in economic terms. Three examples might suffice here:

- (1) The Public Law Project advocated the introduction of a pre-litigation questionnaire in 1996 arguing that it would reduce "costs risk for applicants".¹¹⁹
- (2) Legal aid applications are decided on the basis of a cost-benefit analysis. According to the Legal Aid Notes for Guidance (1995), no aid will be granted "if the proceedings are not likely to be cost effective, i.e. the benefit to be achieved does not justify the costs."
- (3) A practitioner argues that making submissions at the application stage is a cost-saving device for the respondent: (s)he attends and makes submissions "in the hope of saving [her/]his own future costs which will be incurred if leave is granted."¹²⁰

Thus practising lawyers are not deaf to economic considerations; they do make a brief economic analysis before applying for judicial review.

As far as the economic analysis of law is concerned, judicial review of regulatory orders is an especially promising research theme. Economics and law intertwine in utility regulation: economic concepts, like cross-subsidy ('Hydro Benefit' in Scotland) or cost-benefit analysis (Moreton - case below), are transplanted to a legal environment here. Hence the economic analysis of law may help to understand under what circumstances potential applicants will seek judicial review.

¹¹⁸Trade and Industry Committee: Energy Regulation HC 1996-97 50-ix, page 275. Q.6.

¹¹⁹Stephen Cragg: The PLP's Pre-Litigation Questionnaire In: [1996] JR 71.

¹²⁰Mark Shaw: Costs at the Leave Stage In: [1996] JR 8.

3.8 Economic Model Introduced

The economic approach to judicial review would turn to applicants first, then a formula will be introduced.

3.8.1. Applicants

The starting point here is that any interested party may apply for judicial review against a regulatory decision.¹²¹ As a rule, two groups of applicants exist: (i) Licensees and (ii) Customers. The latter group includes (a) customers of utility companies; plus (b) pressure groups.¹²² The economic approach to judicial review assumes that the difference between the behaviours of (a) and (b) is marginal: hence this group will be referred to as Customers.

It is further assumed that Customers (i) always have a free choice whether (a) to apply for judicial review or (b) not; and (ii) they are rational profit maximisers when opting for (a) or (b): tactical challenge is excluded.

3.8.2 The formula

If (i) and (ii) are simultaneously assumed then applicants will seek judicial review if

$$(P_{app} - P_{reg})R_{app} > C_{app}$$

where

- P_{app} probability that judicial review will be granted as estimated by the applicant;
- P_{reg} probability that judicial review will be granted as estimated by the regulator;
- R_{app} remedy as valued by applicant; and
- C_{app} costs incurred by the applicant.¹²³

In the discussion below Probability, Remedy and Cost will be expressed as either low or high. The reason for preferring 'low - high' to figures is discussed under 3.9.2 below. Numbers are not indispensable to the economic analysis of law: as Professor Richard Posner notes, the economic analysis of law "need not be conducted at a high

¹²¹House of Commons: Trade and Industry Committee: Energy Regulation, HC 50-I, 1996-7, point 169., page lix.

¹²²About the standing of pressure groups to seek judicial review, see: Kris Gledhill: Standing, Capacity and Unincorporated Associations In: [1996] JR 67.

¹²³For background to formula see: Richard A. Posner: Economic Analysis of Law (Little, Brown and Company, 1992) §21.5

level of formality or mathematization. The heart of economics is insight rather than technique."¹²⁴

3.9. Formula Applied

Not many regulatory orders were impugned between 1984 (OFTEL established) and 1997. The Trade and Industry Committee noted that "there have been few judicial reviews" in the utilities sector.¹²⁵ What it means is that more often than not the left-hand side of the formula is smaller than Capp; thus potential applicants do not challenge regulatory orders before the court. Why is it so ? To answer that question the three elements of the formula should be analysed in some detail.

Applying the above formula to

- **Regina v. Director General of Gas Supply & another, ex parte Smith and another** (QBD), 1989 (Lexis, 31 July 1989);
- **Regina v. Director General of Electricity Supply, ex parte Redrow Homes (Northern) Ltd.** (QBD), 1995, (Lexis, 3 February 1995)
- **Regina v. National Rivers Authority, ex parte Moreton** (QB), 1995 (Lexis, 13 September 1995);
- **Regina v. Director General of Rail Franchising, ex parte Save Our Railways** (CA), 1995 (Lexis, 15 December 1995);
- **Mercury Communications Ltd. v. Director General of Telecommunications and another** (HL) [1996] 1 All ER 575;
- **In the matter of Applications by Sherlock and Morris for Judicial Review** (QBD), 1996 (Lexis, 29 November 1996);
- **Regina v. Director General of Telecommunications, ex parte British Telecommunications plc.** (QBD), 1996 (Lexis, 20 December 1996);
- **Regina v. Director General of Electricity Supply, ex parte Scottish Power plc.** (CA), 1997 (Lexis, 3 February 1997)

three conclusions would follow:

3.9.1. Probability

Nothing much should be said here. It is a well-known fact that the vast majority of applications falls through in Britain: it is more likely than not that the original regulatory order will not be quashed. As far as the above list is concerned, judicial review was granted in Smith -, Redrow Homes -, Save Our Railways - and Scottish Power - cases; that is four out of ten. The overall picture is not more promising: (a)

¹²⁴Richard A. Posner: The Future of Law and Economics Movement in Europe. International Review of Law and Economics 17:3-14, at 14.

¹²⁵House of Commons: op.cit., point 169.

no judicial review against decisions of the Takeover Panel has succeeded so far;¹²⁶ and (b) 6.4% of the total number of applications for judicial review against decisions of the Home Office were successful between 1991 and 1996.¹²⁷ Hence P_{reg} is high: regulators may be optimistic that the court will not set aside regulatory orders challenged.

Turning to P_{app} , the first point is that an applicant may never be sure whether her/his application will be successful. As a rule, judicial review jurisdiction is discretionary:¹²⁸ it is up to the court whether judicial review will be granted. Thus applicants should proceed with caution when estimating the probability that her/his application will be successful. The Sherlock & Morris - case is a reminder: although Kerr J found that "the applicants are, prima facie, entitled to have the decisions of NIE quashed", he did not "accede to the applications for judicial review." Hence P_{app} tends to be low.

If P_{reg} is high and P_{app} is low then $(P_{app} - P_{reg})$ will be low; and it must be low. Otherwise disputes between regulators and regulatees would not be negotiated but referred to the court.

3.9.2 Remedy

It may be useful to make an introductory point here. R_{app} should not be confused with the monetary value of claims, and this is for two reasons:

- (i) The monetary value of certain claims may not be established. The Moreton - case is a good example here. Ms. Moreton is "a regular swimmer in the sea at Tenby"; she was concerned "about the effect of the increased effluent discharge . . . on the quality of the bathing water where she swims." What was the monetary value of R_{app} in this case? The formula set forth above presumes that Ms. Moreton had a positive R_{app} in her mind; otherwise she would not have applied for judicial review. But it is pure guesswork to express R_{app} as hundreds or thousands of pounds now. Thus the economic analysis of judicial review might run into practical difficulties if R_{app} were the monetary value of claims.
- (ii) Should R_{app} stand for the sums of money at stake, it would simply reflect the well-known fact that Licensees have bigger financial muscles than their customers. For example, the applicant reckoned in Scottish Power that an additional GBP40m revenue may be collected until the next price review (1998) if the application for judicial review were granted. On the other hand, a gas customer was suing for as little as GBP198.19: Pill J himself commented in Smith that "the sum of money involved is not large." The point here is that if

¹²⁶House of Lords: Hansard, 14 January 1997, Column 164.

¹²⁷House of Commons: Hansard, Written Answer, 16 July 1997.

¹²⁸Peter Cane: An Introduction to Administrative Law (Clarendon Press, 1996), page 70.

Rapp were the same as the value of claims it would be always high for Licensees and low for Customers. But Rapp has a more complex role to play in the formula.

It should be recalled that Rapp was defined above as *Remedy as valued by applicant*. The economic analysis of law would underline that applicants consider two factors in deciding whether to seek judicial review: (i) Lawfulness and (ii) Action. The two terms and the difference between them may be explained as follows:

(i) Lawfulness

All the cases listed above may be reduced to a YES - NO binary code: either the regulator's decision is legally 'respectable' or not. Either he complied with a direction given to him by the Secretary of State or not (Save Our Railways - case); Either he has the power to make certain licence modifications or not (British Telecom - case); Either he must determine a dispute referred to him or not (Redrow Homes - case); and so on. The economic analysis will refer to this YES - NO point as Lawfulness. It is the classic domain of judicial review jurisdiction. Judges are well placed to make decisions about the Lawfulness of regulatory orders. But Lawfulness is not the full story in the regulatory game: the emphasis is on Action.

(ii) Action

If Lawfulness has been decided in favour of the applicant, the "And what's next ?" question will arise. A new regulatory order will be issued in accordance with the judgement of the court: it will spell out Action. The link between (a) judgement and (b) Action is of crucial importance. Applicants may not worry about the Lawfulness of a regulatory decision if, and so long as, it does not harm their economic or other (e.g. Moreton) interests. They would like to know what Actions will follow once the regulator's decision has been quashed. Thus applicants want judicial review to cover Lawfulness and Action.

The point here is that applicants are looking for remedies that address both Lawfulness and Action. Six kinds of orders may be granted under the law of England: there are (i) the 'trilogy of prerogative orders' (certiorari¹²⁹, mandamus¹³⁰ and prohibition), (ii) declaration¹³¹, (iii) injunction and (iv) damages.¹³²

¹²⁹Scottish terminology: Reduction. John St. Clair and Neil F. Davidson: *Judicial Review in Scotland* (1986), point 4.02.

¹³⁰There is no mandamus in Scots law; the nearest equivalent is 'Implement'. Tom Mullen: *Introduction to Scottish Judicial Review* In: [1996] JR 107.

¹³¹Scottish terminology: Declarator. John St. Clair and Neil F. Davidson: *op. cit.*, point 4.06.

Declaration and mandamus would be the best choices, perhaps: they may determine what Action the regulator must take. It is no surprise then that these orders are popular among applicants. Declaration was sought in, for example, Smith, Scottish Power, British Telecom, Mercury. The courts have full discretion as to the form of judgements under British administrative law. Judges tend to keep their involvement in the regulatory game to the minimum: they are willing to set aside the original resolution but other remedies may not be granted. The best examples are Scottish Power and Smith: the original regulatory decision was quashed but no further orders were made, although the applicants were seeking other remedies. It is unsatisfactory: judicial review settles Lawfulness but the judgement is likely to be reticent about Action. As a rule, certiorari or a "remission with a direction to consider"¹³³ do not determine what Action the regulator shall take. It is for the regulator to reconsider the matter impugned: (s)he is the decision-maker.

There are exceptions: certiorari may point to the only legally acceptable Action in certain cases. Once the court has ruled in favour of the applicant on Lawfulness, the course the regulator "should lawfully take will often be obvious."¹³⁴ For example, the applicants had been disconnected in Smith or Sherlock & Morris. If judicial review is granted, it is likely that they will be reconnected. As a rule, certiorari may determine Action when applicants are complaining about a *past* grievance; like disconnection, payment of excessive connection charge (Redrow Homes) and the like.

But Licensees apply for judicial review so as to influence *future* regulatory actions. For example, Lord Slynn commented in Mercury that the plaintiff was "seeking to clarify position for *future* negotiation and determination." The Scottish Power - case is another example. Although it was a challenge against the currently operational price formula, the applicant's main worry was not the 1994/95 - 1997/98 period. What the applicant tried to achieve was that the September 1994 price proposals, which retained the total market definition of GBY, will not "set a precedent for *future* regulatory reviews." The setting aside of the original decision will not satisfy Licensees in the cases mentioned above. As was noted above, the order of certiorari is reticent about Action: the Director General may come to the same decision (s)he previously made.¹³⁵ For example, the Director General of Telecommunications made it clear in Mercury that he adhered to his original determination. Certiorari would not have been a terribly useful order in this case. Thus Licensees want judicial review to go beyond Lawfulness: judgements should address Action.

Judges disagree. As Sir Thomas Bingham, MR, put it in the Save Our Railways - case, "Our task begins and ends with review of lawfulness of what has been done". As a rule, the courts confine their attention to Lawfulness: judges try to steer clear of Action. Thus judges prefer certiorari to declaration: and they may impose their

¹³²Michael Fordham: Judicial Review Handbook (John Wiley & Sons, 1997), para 24.1.

¹³³Richard Clayton and Hugh Tomlinson: Judicial Review Procedure (John Wiley & Sons, 1997), para 3.2.3.

¹³⁴Ibid.

¹³⁵Michael Fordham, op. cit., para 4.1.3.

preferences on potential consumers. As was mentioned above, judges have full discretion as to the form of order(s) to be granted: the application may be for mandamus and declaration, but the court may issue an order of certiorari (Smith and Scottish Power - cases).

What does it mean in terms of the formula ? The main point here is that Licensees and Customers have different views about Remedy. As far as Licensees are concerned, Rapp will be high if judicial review deals with both Lawfulness and Action. Declaration or mandamus would be ideal remedies: they could indicate what Action shall follow once the original order has been quashed on the ground of Lawfulness. Thus Rapp will be high if declaration or mandamus were likely to be granted. But judges have a certiorari-friendly policy. They intend to limit their involvement to Lawfulness; Action is not their concern. This judicial approach devalues Rapp. Hence Remedy will be **low for Licensees**: they cannot predict from the decision on Lawfulness what Action the regulator will take.

As far as Customers are concerned, the certiorari-friendly policy is less problematic: an order to quash may point to the only acceptable Action. Thus Remedy may be **high for Customers**. The importance of this point will be apparent in a moment.

3.9.3. Costs

It is common ground that judicial review is costly. Potential consumers will incur hefty expenses: it cost on average GBP50,000 to bring a judicial review case in 1995.¹³⁶ One of the reasons for the relatively high cost is that legal fees are allocated on the basis of the 'loser-pay-all' principle in Britain. If I sue you before a British court and my application is NOT successful, then I have to pay two sets of solicitors and barristers - yours and mine. By contrast, each party bears its own cost in the US. The 'loser-pay-all' principle discourages potential applicants in Britain: only (a) the very rich (i.e. utilities) and (b) the 'sufficiently' poor (i.e. those eligible for legal aid) will seek judicial review. The vast majority of utility customers is somewhere in-between (a) and (b): as a rule, they will not run the risk of incurring hefty legal expenses.

And legal expenses are not the full story here: judicial review tends to increase the overall cost of regulation. A consensus-driven system of utility regulation operates in the UK. An application for judicial review flies in the face of the '*Negotiate but do not litigate* !' principle. Dragging a Director General to court will re-arrange relations between regulators and regulatees: this is the phenomenon known as 'juridification'. Increased judicial review will slow down the regulatory machinery.¹³⁷ It is bad news for the regulatees: regulation will be more time consuming and, consequently, more expensive. Thus judicial review is likely to put regulatory costs up.

¹³⁶The Independent, 2 August 1995.

¹³⁷Colin Scott: The Juridification of Regulatory Relations in the UK Utilities Sector (unpublished paper, 1997), page 29.

This point does not apply to the other group of consumers. Unlike Licensees, Customers do not negotiate with regulators on a day-to-day basis. The fact that the regulatory process may slow down does not disturb them. Thus increase in regulatory costs is not a cause for concern in the case of Customers.

Furthermore, some Customers may receive state aid when challenging the validity of regulatory orders. For example, the Smiths and Ms. Sherlock were dependent on DHSS benefit: they were presumably on legal aid. Thus judicial review was available on a free-of-charge basis in the Smith - and Sherlock & Morris - cases.

The final point here is that the more applications for judicial review are there, the more expensive utility regulation will be; Cost is likely to go up. Licensees will get the lion's share of regulatory costs; they will have high C_{app} . But C_{app} is low for Customers. Actually, some of them may get legal aid to impugn the validity of regulatory orders.

The main points of the above discussion may be re-stated briefly: (a) Probability tends to be **low** for Applicants. (b) Remedy would be **high** if orders other than certiorari were granted. For the time being R_{app} is **low** for Licensees: judges pursue a certiorari-friendly policy. The granting of other prerogative orders or declaration are more the exception than the rule; and (c) Cost is **high** for Licensees and **low** for Customers.

According to the formula set forth above, potential consumers will opt for judicial review if $(P_{app} - P_{reg})R_{app}$ is bigger than Cost. As was mentioned above, Probability is low. And it shall remain so: high P_{app} would open the floodgates for judicial review applications. Hence the left-hand side of the formula may be bigger than C_{app} if (i) Remedy is high, or (ii) Cost is low.

Two concluding remarks may be made here:

- *Licensees* - Cost is high. Thus they will only apply for judicial review if Remedy is high. But R_{app} is actually low: certiorari is the preferred form of order. Remedy would be high for Licensees if mandamus or declaration were granted more frequently; while
- *Customers* - Cost is low; and Remedy is high here. Customers are complaining of past grievances an order to quash may redress effectively.

The economic analysis would conclude then that the certiorari-friendly policy may discourage Licensees from seeking judicial review: they would have more incentives to turn to the court for help if judges were inclined to make orders of mandamus and/or declaration. The judiciary's practice concerning the form of orders granted will influence the future number of applications for judicial review.

3.10. Towards arbitration ?

If the courts are unwilling to supervise the operation of the regulatory agencies, who else should do this job ? The likely direction of development will be towards alternative dispute resolution techniques. In principle, disputes between regulators and regulated may be arbitrated both in England and in Scotland. As far as the law of Scotland is concerned, the Stair Encyclopaedia makes the following declaration about the scope of questions which may be referred to arbitration:

. . . in general every matter may be made the subject of arbitration with regard to which the parties have a dispute and over which they possess a sufficient power of disposal.¹³⁸

The Encyclopaedia gives specific examples of matters which are not subject to arbitration. These include question of domicile, legitimacy, subsistence or otherwise of marriage, whether a party is an alien or a British subject, and obligation which are illegal or *contra bonos mores*.¹³⁹ Unless regulatory orders fall into the last group, as some Labour supporters seem to think, no theoretical difficulties exists as to the arbitrability of regulatory decisions. For example, arbitrators could have interpreted the two terms that were in dispute in *Mercury*. This case did not involve public rights or questions in which the public have an interest. The parties could have opted for arbitration.

Regulators and regulated may consider to arbitrate future disputes. The **electricity** sector took the lead in this direction. Prior to the privatisation of the distribution companies a general arbitration agreement was executed whereby all the parties agreed to refer future disputes to a panel of arbitrators. No reference has been reported under this agreement to date. Similar developments may occur in the **gas** sector. British Gas plc. recommended that the Monopolies and Mergers Commission should arbitrate in any dispute between OFGAS and the company.¹⁴⁰ Furthermore, two adjudicating bodies were established in the **rail** industry to resolve disputes without recourse to court.¹⁴¹

The main point here is that arbitration would serve the interests of the parties better than the courts do. Arbitration would offer the following benefits:

As to cost and time - The cost of a short arbitration procedure is likely to be less than the overall costs of litigation before the courts. Furthermore, arbitration provides a high degree of privacy. Regulators could avoid publicity which may help to preserve much-needed working relations for the future.

¹³⁸The Stair Memorial Encyclopaedia, Volume 2., para. 413.

¹³⁹Ibid, para. 414.

¹⁴⁰The Financial Times, 16 January 1996.

¹⁴¹Jeffrey Goh: Privatisation of the Railways and Judicial Review In: [1996] 7 Util LR 42.

As to suitability of the final product - Compared to an order of the High Court, an arbitration award may better fit the practical needs of the parties. Arbitration is not a supervisory jurisdiction; the final award need not be restricted to a declaration or to the setting aside of the original order. If the arbitration agreement is so drafted, the arbitrators may rule on the merits of the regulatory decision impugned. At the end of the arbitration process the applicant may end up with a final version of the new order. As was shown above, the Royal Courts of Justice cannot provide this kind of service due to jurisdictional restrictions.

As to high risk - Arbitrators tend to be less concerned with broad public policy arguments than the ordinary courts are. Regulated utilities may expect to obtain the remedy sought if the disputed is arbitrated, provided that they can show a strong case (Cf: Sherlock & Morris)

To summarise, arbitration appears to be a less risky method of dispute resolution than judicial review. This method of dispute resolution does not suffer from the three short-comings of judicial review discussed above. Some regulated companies already indicated their willingness to switch to arbitration. It is up to the regulatory offices now to make the necessary steps in this direction.

Conclusion

This chapter has tried to find out why judicial review is a relatively rare remedy in the post-privatisation regulatory regime. The main point is that judicial review does not satisfy the practical needs of regulated companies, and this is for the following reasons:

- Judges do not intend to participate in the regulatory game. As Sir Thomas Bingham put it in Save Our Railways, " . . . the court should not intervene [in the regulatory process] unless it is quite clear that it should, . . .".
- Remedies granted do not solve the problem. A declaration or the setting aside of the original order will not end the dispute between the regulator and the regulated. (Scottish Power; and Smith) On the other hand, legal proceedings could seriously damage day-to-day co-operation with the regulator.
- Regulation is highly personalised. After a successful judicial review the regulated company must go back to the same regulator. Only one person, the competent Director General, could issue a new order.

- The economic analysis of law concluded that judicial review is not the most efficient dispute resolution technique. The non-interventionist approach of the judiciary may discourage potential applicants from seeking judicial review. Thus regulated utilities and their customers may refer future disputes to arbitration (as opposed to judicial review).

Chapter 4.

The Success of Privatisation - how could it be appraised ?

A discussion about the success of privatisation is not an exact science; the same transaction may please some and disappoint others. For example, the Department of Education and Science told the Committee of Public Accounts that the sale of the Plant Breeding Institute "represented a wholly satisfactory outcome".¹ As will be discussed in Part I. below, the Treasury actually lost GBP38.85m. One may wonder then whether it was really a 'satisfactory outcome'.

How should the success of privatisation transactions be appraised ?

According to the findings of Dennis Swann, commentators approach the economic impact of privatisation from three angles:

- Theoretical issues: "whether ownership is itself a significant factor";
- Relative efficiency of public and private enterprise; and
- Actual experience in UK industries pre- and post-privatisation.²

High level economics and a load of empirical studies are a must to research any of these issues: this thesis will take a less sophisticated approach. Let us suppose that you and I agree that we will walk from the Royal Commonwealth Swimming Pool to the top of Lion's Head and back within five hours. It would be quite natural if we were to agree that our performance shall be tested against the objective agreed (i.e. (a) top of Lion's Head and (b) back within five hours). If

- (a) you return within five hours, while I do not; and/or
- (b) you reach Lion's Head, while I do not, then

there is no doubt that you succeeded and I failed.

The same approach may be adopted to assess the success of the sale of state-owned assets/companies. The 'what happened' should be compared with the 'what should have happened': results should be tested against the objectives of privatisation. In theory, this exercise should be straightforward - only two simple questions should be answered: (i) What objectives and targets were set ? and (ii) Did the government achieve those targets ? Yet this approach does not seem to work in practice: the British government did not have a clear set of objectives. Sir Christopher Foster notes that "there was no clear or comprehensive government statement of its [i.e.

¹Committee of Public Accounts: Sale of the National Seed Development Organisation and Part of the Assets of the Plant Breeding Institute HC 218 1988-89 [hereinafter referred to: HC 218 1988-89], page v., point 3. and page 5., Q. 1833.

²Dennis Swann: *The Retreat of the State* (1988), page 296.

privatisation] objectives" in the first years of privatisation.³ Peter Jackson agrees; he points out that

Privatisation was a policy which was stumbled upon. The incoming 1979 Thatcher Government did not have a well established privatisation policy. Instead, privatisation policy emerged or evolved. It was a policy which enabled politicians the means of achieving a number of policy objectives.⁴

Peter Saunders and Colin Harris also argue that:

There has never been an official government statement about the objectives behind privatization. Over time, of course, various ministers have delivered speeches or written articles defending and justifying the policy, but the reasons they have given have seemed to change as the years have gone by and they have sometimes contradicted each other.⁵

Academic writers finished the job the government did not (or could not) do: university professors compiled lists of privatisation objectives. Actually one was not an authority on privatisation unless (s)he had her/his own list of 'major objectives of privatisation'. For example, Peter Saunders and Colin Harris list the following objectives:

- to reduce public sector borrowing;
- to increase efficiency;
- to weaken the power of the public sector trade unions;
- to enhance managerial autonomy and initiative; and
- to create 'popular capitalism'.⁶

Christopher Johnson defined four objectives:

- to reduce the role of the state in the economy;
- to raise money for the public finances;
- to improve economic performance by increasing competition; and
- to widen share ownership.⁷

³C.D. Foster: *Privatization, Public Ownership and the Regulation of Natural Monopoly* (1992), page 116.

⁴Peter M. Jackson: *The Privatisation of the British Public Sector: An Assessment of a Policy Innovation* In: Mario Baldassarri, Alfredo Mucchiati and Diego Diacertino (eds): *The Privatisation of Public Utilities: The Case of Italy* (1996), page 76.

⁵Peter Saunders and Colin Harris: *Privatization and Popular Capitalism* (1994), page 18.

⁶Peter Saunders and Colin Harris: *op. cit.*, page 19.

⁷Christopher Johnson: *The Economics of Britain's Electricity Privatization* In: *Lloyds Bank Annual Review: Privatization and Ownership* (1988), page 60.

According to Cento Veljanovski, the following emerged as the major objectives of privatisation:

- to reduce government involvement in the decision-making of industry;
- to permit industry to raise funds from the capital market on commercial terms without government guarantee;
- to raise revenue and reduce the public sector borrowing requirement;
- to promote wide share ownership;
- to create an enterprise culture;
- to encourage workers' share ownership in their companies;
- to increase competition and efficiency; and
- to replace ownership and financial controls with a more effective system of economic regulation designed to ensure that benefits of greater efficiency are passed on to consumers.⁸

And, finally, Brian McBeth summarises the objectives of privatisation as follows:

- The efficiency of publicly-owned assets would improve while market discipline would be restored in certain key areas;
- Government involvement in public enterprise decision-making would be reduced, so that companies would be more free to allocate their financial, physical and human resources to the most appropriate areas;
- The financial burden of the government and, most importantly, its borrowing requirement would decrease;
- The government's revenues would receive a one-off boost, and then would be increased by improved tax revenues; and
- Financial market development would be stimulated.⁹

The government could have put an end to the 'battle of lists' by publishing a paper on the objectives of privatisation: but it was never done. As Simon Jenkins writes, "The cabinet never saw a white paper putting the case for privatization."¹⁰ Thus it was not quite clear what goals the government actually pursued. According to Oliver Letwin, this is not a problem: he warns that searching for a single stream of objectives is "dangerously naive and unproductive."¹¹ But how may one decide whether the goals of privatisation have been achieved if there are no pre-established objectives against which the success of transactions could be tested ?

⁸Cento Veljanovski: *Selling the State* (1987), page 8.

⁹Brian McBeth: *Privatisation. A Strategic Report* (1996), page 9.

¹⁰Simon Jenkins: *Accountable to None* (1995), page 25.

¹¹Oliver Letwin: *Privatising the World* (1988), page 27.

The starting point is that there are three motives on the list of all the commentators quoted above:

- maximizing revenue;
- extending share ownership; and
- improving economic performance.¹²

For the purposes of this discussion, let us suppose that these were the 'core objectives' of privatisation. Having answered question (i) as set forth above, the discussion may move on to question (ii): Did the government achieve these objectives? This Chapter will try to answer that question.

An introductory point should be addressed here. The Preface has promised that this thesis will concentrate on utility privatisation. Yet this Chapter will analyse the sale of some non-utility companies, like Plant Breeding Institute, the trust ports, and British Coal. The reason for 'straying away' from the utilities sector is that the transactions mentioned above are prime examples of 'less successful projects'; i.e. disposals which did not live up to expectations. In the case of 'less successful projects' there is a gap between (a) objectives and (b) reality; and those gaps are a must if one wishes to analyse the success of privatisation in Britain. The main reason for discussing the sale of the Plant Breeding Institute, trust ports, and British Coal is that such 'gaps' are easily visible in the case of these projects.

Yet detecting 'gaps' would be more complicated in the utilities sector. So far as the first two objectives listed above are concerned, one would find rather impressive numbers. (a) The government collected *millions* of pounds from the sale of electricity, gas, telecommunication, and water shares; the facts are as follows¹³:

Industry	Privatisation proceeds (GBP million, financial year)		
Electricity (England & Wales)	3,134 (1990 - 91)	2,329 (1991 - 92)	1,465 (1992 - 93)
Electricity (Scotland)	1,112 (1991 - 92)	907 (1992 - 93)	709 (1993 - 94)
Natural gas	1,820 (1986 - 87)	1,758 (1987 - 88)	1,555 (1988 - 89)
Telecommunication	1,358 (1984 - 85)	1,246 (1985 - 86)	1,081 (1986 - 87)
Water	423 (1989 - 90)	1,487 (1990 - 91)	1,485 (1991 - 92)

TABLE 7.: Privatisation proceeds

¹²For example, John Ernst: *Whose Utility?* (1994), page 83.

¹³Source: H.M. Treasury: *Her Majesty's Treasury Guide to the UK Privatisation Programme* (August 1995), Table 5.6.

(b) It is a fact that *millions* of people subscribed for utility shares. For example, around a quarter of existing shareholders increased their holdings, and "over 800,000 people became new shareholders" in National Power/Power Gen when the residual stakes were sold off in 1995¹⁴ (extending share ownership).

This thesis does not intend to discuss whether utility privatisation met the 'maximizing revenue' and 'extending share ownership' objectives; rather (i) Parts I. and II. will refer to non-utility projects which *certainly* failed to satisfy the two objectives mentioned; while (ii) Part III. will argue that utility privatisation seems to have difficulties with the third objective (improving economic performance).

Hence the structure of this Chapter will be as follows: Part I. will be concerned with the objective of 'maximizing revenue': the sale of (i) British Coal, (ii) British Energy plc., (iii) Plant Breeding Institute and (iv) the trust ports will be analysed here. Part II. will discuss the other two core objectives: it will be argued that the structure of share ownership did not change fundamentally in the UK, thus it is open to question whether the 'widening share ownership' objective has been achieved. Part III. will deal with the restructuring of public utilities. The discussion will conclude that 'the improving economic efficiency' objective may not be achieved unless utility markets are restructured and liberalised.

Part I.

Maximizing Revenue

Every newspaper reader is familiar with the 'maximizing revenue' objective in Britain. It is the 'family silver' argument: did the Tory government sell off the 'family silver'? Those who answer this question in the affirmative believe that nationalised industries were undervalued at privatisation. The Conservative party disagrees; the two most frequently used arguments are as follows:

- Giant transactions

The disposal of public utilities was among the biggest ever flotations in Europe: the sale of the first tranche of British Telecom shares was "the biggest equity offering ever made anywhere in the world."¹⁵ It was necessary to set a price at a relatively low level in order to guarantee that millions of investors would purchase British Telecom, British Gas, water or electricity shares.

¹⁴Sir George Young Bt MP: Speech to World Privatisation Conference In: H.M. Treasury: op. cit., pages 77 - 82., at 80.

¹⁵Simon Jenkins: *Accountable to None* (1995), page 29.

- Maximizing revenue overridden

In addition to 'maximizing revenue' other objectives, like the widening of share ownership or the need to close a transaction as soon as possible, were also considered in setting the offer price. Cento Veljanovski notes that when the government tried to widen share ownership the disposals were "a bit of a bargain": "The shares must appear a good buy to the man in the street."¹⁶ Simon Jenkins makes a similar point: Margaret Thatcher "stressed the need to sell fast, and if necessary cheap, to the widest number of shareholders."¹⁷ Bryan Hurl delivered the final judgement on this point:

. . . positive economics usually yields to the '**political utility function**': governments maximize short-term political vote-catching returns at the expense of resource optimization. Throughout the 1980s the silver has been under-valued in an attempt to establish 'people's capitalism'.¹⁸

The issue whether companies were undervalued at privatisation or not has been discussed in hundreds (if not thousands) of publications. This Part will attempt to approach the 'maximizing revenue' objective from a different perspective. The starting point here is that the Treasury did not (i) retain or (ii) collect privatisation proceeds in full in the case of certain transactions. This Part will refer to such projects as 'less successful transactions'. The attraction of this approach is that it is not concerned with the 'undervalued or not' dilemma; the 'maximizing revenue' objective was obviously not achieved if "it cost the government more to get rid of the industry than it received back in revenue".¹⁹

Two issues should be analysed in connection with less successful transactions: (i) Liability of privatisation candidate; and (ii) Mismanagement. Liability will be considered in connection with (a) the coal industry and (b) nuclear power stations. Mismanagement will be discussed in the light of the (c) PBI-sale and (d) the disposal of the trust ports.

Mining Subsidence and Nuclear Decommissioning

After the giant flotations, like British Telecom plc. (1984), British Gas plc. (1986), English and Welsh electricity companies (1991), privatisation seemed 'unstoppable'²⁰: no political party or trade union could deter the government from offering further companies for sale. Yet two long-awaited projects were not coming forward: in 1993

¹⁶Cento Veljanovski: *Selling the State* (1987), page 102.

¹⁷Simon Jenkins, *op. cit.*, page 32.

¹⁸Bryan Hurl: *Privatization and the Public Sector* (1988), page 56. **Bold original.**

¹⁹Peter Saunders and Colin Harris: *Privatization and Popular Capitalism* (1994), page 53.

²⁰The Financial Times, 20 November 1992.

the Treasury referred to the privatisation of the coal and the nuclear power industries as 'major privatisations in hand'²¹. These transactions were completed in 1995 and in 1996 respectively. If not political opposition, what else could hold up the sale of British Coal and the nuclear industry? While the disposal of coal mines seems to have nothing common with the flotation of British Energy plc.²², the two projects are actually closely linked: both of these industries were beset with 'open ended'²³ obligations.²⁴ The purpose of this Part is to examine how such claims were parcelled out between the government and investors (a) in the coal industry and (b) in the nuclear energy business.

4.1 British coal

Preparations for the sale of coal mines took some eight years in Britain.²⁵ It would not have been an unusually long period in the utility sector²⁶, however coal mining is not a natural monopoly. Hence the two most likely reasons for delay, ownership and economic regulation, may be ruled out:

- Ownership of Coal

Pursuant to the Coal Industry Nationalisation Act 1946, interests in unworked coal and in coal mines were vested in the National Coal Board; these interests were re-transferred to the newly established Coal Authority in 1994²⁷.

- Price of coal

The price of coal is not regulated. Price regulation would be superfluous: coal is in direct competition with alternative sources of energy, especially with natural gas.

²¹HM Treasury Guide to the UK Privatisation Programme (1993), page 23., point 132.

²²The coal industry has been in the **decline** since 1957 (R. Kelf-Cohen: Twenty Years of Nationalisation (1969), page 210.), while nuclear may be the **power of the future**. The former was a **trade sale** in a closed tender; the latter was a public **flotation**.

²³Open ended obligation: potential claims the total value of which may not be assessed precisely at privatisation but likely to be detrimental to the profitability of the business concerned.

²⁴Lord Crickhowell, Chairman of the National Rivers Authority made a similar point in 1994; however, his comment went unnoticed in the financial press. See: The Guardian, 15 April 1994. see also: C.D. Foster: Privatization, Public Ownership and the Regulation of Natural Monopoly (1992), page 134.

²⁵The Financial Times, 23 November 1993.

²⁶According to C.D. Foster, preparation for the disposal of British Gas plc. took more than five years. See: C.D. Foster: Privatization, Public Ownership and the Regulation of Natural Monopoly (1992), page 130.

²⁷Section 7 of the Coal Industry Act 1994.

Competition was so fierce in the past that coal prices were 'absurdly' low in relation to costs.²⁸

Hence a third issue may be blamed for the long delay: the liability of mine operators. Two major sources of liabilities were identified in the coal industry: (i) environmental 'time-bombs'; and (ii) subsidence.²⁹

(i) Environmental issues

A commentator noted in early 1995 that environmental time-bombs were the "major challenge facing British Coal's new owners."³⁰ Water pollution was of special concern in the coal industry. On average, 2.3 tons of water must be pumped from a British mine to extract a ton of saleable coal.³¹ For example, British Coal pumped 25m gallons of water every day from the Durham pits; running the eleven pumping stations cost GBP6m a year.³² Underground water remains a source of potential liability after the closure of mines. If not pumped for certain period of time, water from abandoned mines starts to leak. The Commission on Energy and the Environment reported in 1981 that 0.5m gallons per day had been overflowing into the river Girvan since 1979.³³ The mine closure programme of the early 1990s compounded the problem: according to the National Rivers Authority, 200 km of rivers in England and Wales were polluted by leaks from abandoned coal mines in 1994.³⁴ In addition to water pollution, flooding was also a threat: for example, 10 acres of fields in County Durham were flooded from a single disused pit shaft in 1979.³⁵

The National Rivers Authority published a special report about abandoned mines and water pollution in 1994.³⁶ This document concluded that the Authority had insufficient statutory power to prosecute mine operators for polluting water. Under the Water Resources Act 1991 'permitting' water from

²⁸The Economist, 9 February 1991. World price was around GBP30/ton, while the British Coal price was around GBP43/ton. Source: The Economist, 24 October 1992.

²⁹The Financial Times, 1 June 1994.

³⁰J. Fitzpatrick: British Coal Privatisation. An Examination of the Environmental Issues (1995), page 26.

³¹Commission on Energy and the Environment: Coal and the Environment (1981), Table 7.1. The pumping of water from coal mine is by no means a modern problem. W. Leibniz, philosopher and mathematician, developed windmills to pump minewater in Harz Mountains in the 1680s. Source: The Encyclopaedia Britannica (<http://www.eb.180>), entry: Leibniz, Gottfried Wilhelm.

³²The Financial Times, 1 October 1993.

³³Commission on Energy and the Environment: Coal and the Environment (1981), page 45.

³⁴The Financial Times, 15 April 1994.

³⁵The Financial Times, 22 December 1993.

³⁶National Rivers Authority: Abandoned Mines and the Water Environment (1994)

an abandoned mine to enter controlled water is not an offence.³⁷ While the Water Resources Act 1991 does not apply to Scotland³⁸, Scots law is not different from the law of England on this point. The Stair Encyclopaedia writes that "To permit water from an abandoned mine to enter relevant waters is not of itself unlawful."³⁹ Who shall finance then the minewater pumping and water treatment programmes after privatisation ?

(ii) Subsidence

Houses and lands had been subsiding ever since the introduction of deep coal mining. The liability of mine operators for subsidence damages had a "long and often tangled" history in Britain.⁴⁰ One point should be highlighted from the past of subsidence regulation here: after the passage of the Coal-Mining (Subsidence) Act 1957 British Coal Corporation was obliged to repair damaged property or, alternatively, to pay compensation. The Corporation spent around GBP50m per annum on subsidence.⁴¹ Who shall pick up the bill for subsidence claims after privatisation ?

Environmental time-bombs and subsidence were truly open ended liabilities: nobody knew how much the "large overhang of financial obligations"⁴² would cost, but claims were doomed to be in the region of millions of pounds. It was feared that the total value of claims would make the mining of certain coal uneconomic; past liabilities were reported to exceed profits in some of the five regions offered for sale.⁴³ The Guardian went one step further: the newspaper alleged that liabilities 'are likely' to exceed the total business value of British Coal.⁴⁴ The government acknowledged that questions surrounding the extent of liabilities must be resolved prior to privatisation. Lord Wakeham, the then Energy Minister, told the House of Commons that

³⁷Section 89(3) of the Water Resources Management Act 1991.

³⁸Section 225(3) of the Water Pollution Act 1991. The relevant Act in Scotland is the Control of Pollution Act 1974.

³⁹The Law of Scotland The Stair Memorial Encyclopaedia (1989), Vol. 25., Para. 403. The same act was declared to be an offence under the Rivers (Prevention of Pollution) (Scotland) Act 1951. See: **Lockhart v. National Coal Board 1981 S.L.T. 161.**

⁴⁰The Repair and Compensation System for Coal Mining Subsidence Damage Cmd 235 (1987-1988), page 34.

⁴¹The figure for the 1992-93 business year was GBP46m. Source: The Financial Times, 13 January 1994.

⁴²C. D. Foster: Privatization, Public Ownership and the Regulation of Natural Monopoly (1992), page 134.

⁴³The Financial Times, 13 January 1993 and Energy Committee: Mining Subsidence HC 287 1989-90, page 90., Q. 376.

⁴⁴The Guardian, 15 April 1994.

... there seems no possibility of privatising British Coal without first clearing up the questions of liability and subsidence.⁴⁵

In addition to the government and potential investors, third parties were also keen to see how liabilities will be apportioned. For example, Durham City Council told the financial press that it would seek an injunction against the new mine operator unless "the government spells out where responsibility lies after privatisation".⁴⁶ The Chairman of the National Rivers Authority also insisted that uncertainty over liability should be settled before privatisation.⁴⁷

The main point here is that the history of British Coal privatisation is the story of allocating open-ended liabilities between the private and the public sectors. The underlying rule of this process may be summarised as follows: the more liabilities the government was willing to retain, the higher privatisation proceeds will be. The Environmental Department alluded to this rule in the press: the Department pointed out that making mine owners responsible for liabilities "would have adverse effects on the proceeds to the Government."⁴⁸ Thus the two extremes were out of the question: neither the government nor potential investors could take on **all** liabilities. The former would have been politically embarrassing, the latter would have deterred investors. Hence future claims had to be **portioned out** between the government and investors. After years of negotiations⁴⁹ the following arrangements were in place when coal mines were offered for sale:

Water pollution -

A new Act was passed to assuage potential investors. Under the Environment Act 1995 water from abandoned mines may enter controlled water without legal sanction until 2000; all mines closed before then will be exempt.⁵⁰ After 2000 operators will be fined for polluting controlled water from mines that were in operation after 31 December 1999.

Legislators in other countries are less lenient as far as mine water pollution is concerned. For example, the new Mining Act in Poland burdens operators with the costs of damage caused by dumping water in rivers.⁵¹ It may not be ruled out that the British Parliament exempted mine operators so as to help the privatisation of the coal industry.

⁴⁵HC Debt. 16 January 1990, c. 199.

⁴⁶The Financial Times, 26 January 1994.

⁴⁷The Financial Times, 15 April 1994.

⁴⁸The Guardian, 25 February 1995.

⁴⁹The Financial Times noted that the structure of British Coal privatisation was not shaped out "through debates in Westminster but through government talks with the would-be buyers of British Coal." The Financial Times, 23 November 1993.

⁵⁰Section 60 of the Environment Act 1995; and Section 30J of the Control of Pollution Act 1974.

⁵¹East European Energy Report, January 1994, Vol. 28., page 12.

Mining subsidence -

There was little hope of a compromise on this issue. Bidders lobbied for leaving subsidence claims with the newly created Coal Authority⁵²; on the other hand, the Department of Trade and Industry insisted that coal operators must assume responsibility for subsidence.⁵³ The Parliament had the final word on this point; the Coal Industry Act 1994 provides that

- References to the British Coal Corporation in the Coal Industry Act 1991 are to be replaced with references to the responsible person (i.e. the person with responsibility for subsidence affecting the land which has been damaged).⁵⁴
- The responsible person is the licence holder where the land is within the licensed area; in any other case (e.g. when the land is not within a licensed area) the Coal Authority shall be the responsible person.⁵⁵
- "... a person is the responsible person in relation to any subsidence damage whether that damage was caused or occurred *before or after* the time that person became the person with responsibility for subsidence affecting the land in question."⁵⁶

The main points here are that (i) licence holders are responsible for subsidence damages within their licensed areas irrespective of the date of mining activities causing the subsidence; while (ii) the Coal Authority will compensate owners of damaged properties in areas currently not under mining. Hence claims in respect of damages in licensed areas will be passed on to private mine operators after privatisation.⁵⁷ For example, the Coal Authority forwarded 116 such claims to RJB (Mining) Ltd in the first year after privatisation.⁵⁸ To conclude, the government had reason to celebrate on this issue: mine operators are going to pick up the bill for subsidence claims in their licensed areas, even though damage was caused by British Coal.

Yet two additional points should be considered here:

- (i) The Coal Authority is responsible for claims in currently unmined areas. The handling of subsidence claims is actually one of the principal activities of the Authority.⁵⁹ The Authority appears to be the residual body in charge of

⁵²The Financial Times, 14 April 1994.

⁵³The Financial Times, 13 January 1994.

⁵⁴Sections 43 (1) and (2) of the Coal Industry Act, 1994. This amendment logically followed from the new system of licensing - See: Coal Mining Subsidence Act, 1991. A Guide to the Provisions of the Act (1994?), Part II., Section 2.

⁵⁵Section 43 (3) of the Coal Industry Act, 1994.

⁵⁶Section 43 (4) of the Coal Industry Act, 1994. *Italics added.*

⁵⁷Coal Mining Subsidence - A Guide (1994), point 2.4.

⁵⁸Coal Authority: Report and Accounts 1995-96 (1996), page 9.

⁵⁹Coal Authority Accounts 1995-96 HC 549 1995-96, page 1.

historical liabilities, including subsidence.⁶⁰ It will be discussed below what financial resources are available to meet subsidence claims.

- (ii) The Authority effectively underwrites subsidence obligations of the private mine operators. Section 2(1)(c) of the Coal Industry Act 1994 provides that the Authority shall secure that no person will sustain loss in consequence of any failure of a licensed operator to make financial provision for meeting subsidence liabilities. Operators are obliged to put money aside into a special fund to cover subsidence claims; but, as Fitzpatrick notes, ". . . provision for environmental responsibilities may not figure too prominently within budgets [of the new operators]".⁶¹ Thus the Coal Authority may pick up the bill for subsidence claims, if an operator goes into liquidation without leaving sufficient money in the fund.⁶²

Mine water pollution is another source of potential liability for the government. It is to be recalled that mine operators will not be responsible for water pollution until the end of the century. Furthermore, if minewater leaks from a mine which will have been abandoned before 31 December 1999 the operator is exempt from liability. Hence private operators are encouraged to abandon as many mines as possible by 2000. The government will certainly pay for water clearing-up until the end of the century; but this obligation may not cease then if mine operators are shrewd enough to abandon mines before that date.

To conclude, the government got the lion's share of open-ended liabilities in the coal industry; and this is the reason for discussing coal privatisation in this Chapter. The Treasury collected some GBP1bn from the sale of coal mines in December 1994.⁶³ However this amount of money will not be in the Consolidated Fund for too long. Millions must be earmarked for meeting environmental liabilities and subsidence claims. The following payments have already been made in the coal sector:

- British Coal's external financing limit was adjusted from GBP35 to GBP59m in 1995 to reflect the continuing management of various ex-employee liabilities.⁶⁴

⁶⁰The Financial Times, 4 August 1993.

⁶¹J. Fitzpatrick: *British Coal Privatisation. An Examination of the Environmental Issues* (1995), page 25.

⁶²The Royal Institute of Chartered Surveyors warned that the subsidence Estimate of the Coal Authority might prove insufficient. Source: The Financial Times, 4 December 1993. And see also: The Guardian, 20 February 1994.

⁶³RJB Ltd. paid GBP815m for the three English regions; Celtic Energy paid GBP94.5m for the Welsh mines; and the Scottish region went to Mining (Scotland) Ltd. for GBP49m. Sources: The Financial Times, 30 December 1994, and The Guardian, 21 December 1994.

⁶⁴Weekly Hansard, No. 1702 15th November to 17th November 1995, Written Answers, page 12 (17 November 1995).

- The sum of GBP123,940,000 was paid to DTI for assistance to the coal industry under the Appropriation Act 1996, including expenditure on "payments to redundant workers and other liabilities in respect of former employees of the British Coal Corporation and their dependants; and on the costs of the subsidence and other external advisers and statutory arbitration arrangements."⁶⁵
- The Coal Authority received GBP53.5m Grant-in-Aid in the financial year 1995/96; for the 1996/97 financial year the limit was GBP59.7m.⁶⁶ The Authority spent GBP49,506,000 on subsidence claims and GBP5,126,000 on "historic liabilities" in 1995-96.⁶⁷

To sum up, the government spent GBP236.4m on managing coal-related liabilities over the first two business years following privatisation. More than 20% of the total privatisation proceeds has already been 'reinvested' in the coal industry to finance environmental and subsidence liabilities.

4.2 Nuclear energy

The government was once more engrossed with the apportioning of liabilities in 1996 when British Energy plc. was offered for sale. The privatisation of the nuclear power stations was not a routine job: as the CEGB noted, it was "the biggest challenge which faces the government in the whole exercise [i.e. electricity privatisation]".⁶⁸ The nuclear privatisation programme was likely to founder on open-ended obligations. The government did not find a solution to questions like nuclear waste storage or station decommissioning in the run-up to the big electricity sell-off in 1990. Hence nuclear stations were withdrawn from the sale on the grounds that

they were drawing to the end of their lives, and it would not be appropriate to burden the private sector with the significant costs of their operation and closure.⁶⁹

Thus the entire nuclear industry was retained in the public sector:⁷⁰ the English/Welsh and Scottish generators owned or operated no nuclear power stations

⁶⁵Appropriation Act 1996, Class IV., Vote 4.

⁶⁶Coal Authority Accounts 1995-96 HC 549 1995-96.

⁶⁷Coal Authority Accounts 1995-96 HC 549 1995-96., page 13.

⁶⁸Alex Henney: *A Study of the Privatisation of the Electricity Supply Industry in England & Wales* (1994), page 138.

⁶⁹Centre for the Study of Regulated Industries: *The UK Electricity Industry. Charges for Electricity Services 1996/97* (1997), page 2.

⁷⁰At one stage the government proposed that National Power plc. (England and Wales) and the two Scottish companies should own the nuclear stations. This is why the 'golden-share' (See Chapter 3. above) is non-time limited in National Power/PowerGen and in Scottish Power/Scottish Hydro-

at their privatisation⁷¹. Two wholly government owned companies (Nuclear Energy plc. and Scottish Nuclear Ltd.) assumed all nuclear-related liability.⁷²

But this was only a temporary arrangement: liability was to be parcelled out between the private and the public sector prior to the proposed privatisation of the nuclear power stations. Hence a second restructuring was bound to precede the sale of British Energy plc.; the following arrangements were made in March 1996:

- A new company, Nuclear Electric Ltd., was incorporated to take over the non-MAGNOX stations⁷³ of Nuclear Electric plc.;
- Nuclear Electric plc. changed its name to Magnox Electric plc. This company is wholly owned by HM Government;
- Scottish Nuclear Ltd. transferred its MAGNOX stations to Magnox Electric plc.;
- British Energy plc., a newly incorporated company, became the parent company of Nuclear Electric Ltd. and Scottish Nuclear Ltd.⁷⁴

As a result, Magnox Electric plc. owns nine MAGNOX stations; on the other hand, the recently privatised British Energy plc. owns non-MAGNOX stations only. As a rule, MAGNOX stations are near the end of their useful lifetime; they must be closed and decommissioned in the near future.⁷⁵ Three of Magnox Electric plc.'s stations are being decommissioned for the time being.⁷⁶ In contrast, the decommissioning of the first British Energy stations will not be due before 2006.⁷⁷

Thus significant nuclear-related liabilities remained in the public sector, while the profit earning units (i.e. non-MAGNOX stations) were privatised. The main point here is that Magnox Electric plc. will depend on government subsidy in the future. This company has a turnover of GBP0.6bn to finance the currently ongoing decommissioning programme which will cost GBP8bn.⁷⁸ Although the government

Electric. Sources: Nuclear Power and Electricity Privatisation (1989) House of Commons Background Paper No. 230., page 230. and Privatisation of the Electricity Supply Industry (1988), Reference Services. Central Office of Information No. 309/88.

⁷¹National Power plc. PowerGen plc.: Offers for Sale (1991), page 58. and Scottish Hydro-Electric plc. Scottish Power plc.: Offers for Sale (1991), page 39.

⁷²Alex Henney: A Study of the Privatisation of the Electricity Supply Industry in England & Wales (1994), page 141.

⁷³Nuclear stations running MAGNOX reactors. The Prospectus defined MAGNOX reactors as follows: "The first generation of gas cooled nuclear reactor built in the UK in the 1950s and 1960s." British Energy plc: International Offer and UK Public Offer (1996), page 242. More discussion about the MAGNOX programme: Alex Henney: A Study of the Privatisation of the Electricity Supply Industry in England & Wales (1994), pages 130 - 131.

⁷⁴British Energy plc: International Offer and UK Public Offer (1996), page 55.

⁷⁵Andrew Holmes: Privatising British Electricity (1992), page 31.

⁷⁶British Energy plc: International Offer and UK Public Offer (1996), page 55.

⁷⁷British Energy plc: International Offer and UK Public Offer (1996), page 71.

⁷⁸The Financial Times, 31 August 1996.

provided a GBP3.8m financial undertaking to Magnox Electric plc.⁷⁹ it is not clear whether the company will have sufficient funds to finance the decommissioning programme. By contrast, British Energy plc. is in a better financial position. This company had GBP4.2bn total undiscounted decommissioning liability against a turnover of GBP1.7bn in 1996.⁸⁰ In addition, the government halved the level of debts in the balance sheet of British Energy plc. from GBP1,500m to GBP700m.⁸¹ Thus British Energy plc. will be able to cope with decommissioning.

To conclude, the privatisation of British Energy plc. is a less successful transaction: the taxpayer "may have lost out on British Energy sell-off".⁸² Proceeds of GBP1.4bn⁸³ collected from the sale of British Energy plc. will be spent on financing the nuclear liabilities of Magnox Electric plc. As the Chairman of the Public Accounts Committee put it, "Taxpayers may face the costs of nuclear decommissioning if British Energy fails to find all of the cash itself."⁸⁴

And a final point: despite the slimming down of liabilities, British Energy shares had a disastrous debut in the London stock exchange. Share prices fell sharply in July 1996 when two stations were shut down to investigate concerns about the strength of welds in steam pipes.⁸⁵ The performance of British Energy shares was reported to be the worst⁸⁶ since the partial disposal of British Petroleum plc. in 1987.⁸⁷ As a result, the privatisation was not completed until December 1996 when the government sold the last tranche of 81m shares (11.2% of British Energy plc.) to a financial investor.⁸⁸

The Economist reported in connection with coal privatisation that the Treasury attempted to saddle investors with "lots of unpredictable liabilities"⁸⁹; the above discussion has tried to show that this forecast missed the point. It was the Department of Industry and Trade which saddled the Treasury with coal- and nuclear-related obligations. Liabilities did not follow assets in the case of the two disposals discussed above: the government privatised profitable parts of the coal and nuclear industries but retained a great chunk of liability. Thus the sale of British Coal and British Energy plc. are less successful transactions: liability claims will drain privatisation proceeds.

⁷⁹PowerUK, 25 June 1996, pages 14 - 15.

⁸⁰British Energy plc: International Offer and UK Public Offer (1996), pages 13. and 55.

⁸¹Inside Energy, Vol. 6., No. 19., 3 April 1996, page 3.

⁸²The Financial Times, 8 May 1998.

⁸³The Financial Times, 15 July 1996.

⁸⁴The Times, May 8 1998.

⁸⁵The Financial Times, 11 July 1996.

⁸⁶It should be noted, however, that British Energy plc. has seen better days recently. According to The Financial Times, BE shares outperformed other generators in early 1998. The Financial Times, March 14/March 15 1998, Weekend Money, page 4.

⁸⁷The Financial Times, 16 July 1996.

⁸⁸The Financial Times, 4 December 1996.

⁸⁹The Economist, 22 January 1994.

Part II.

Mismanagement -

PBI and the Sale of Trust Ports

This part will discuss two disposals: /A/ Plant Breeding Institute (PBI) and /B/ Trust Ports. Both of these transactions could have been successful: PBI and the trust ports were good investment opportunities, thus purchasers were not in short supply. Yet civil servants did not excel in managing privatisation.

4.3 PBI and the charitable trap

The National Seed Development Organisation (hereinafter: "NSDO") and the Plant Breeding Institute (hereinafter: "PBI") were among "the most prestigious and successful research institutes in the world".⁹⁰ Despite their fame, the business world perhaps did not even know that these organisations existed. Hence the proposed privatisation of NSDO and PBI was expected to proceed without much publicity. Yet quite the contrary happened: the sale was an embarrassing debacle. What went wrong?

The history of the NSDO - PBI transaction may be summarised as follows. The Secretary of State announced in February 1986 that NSDO and a part of PBI would be transferred to the private sector. The Department of Education and Science ("DES") presented an Estimate to the Parliament in December 1986; it was approved on the understanding that the full net proceeds would be remitted to the Consolidated Fund. A memorandum of information had been distributed to potential investors in early 1987⁹¹; three candidates were shortlisted and finally UNILEVER plc. agreed to pay the sum of GBP66m for NSDO and a part of the assets of PBI⁹² in September 1987.⁹³ Considering these facts one would conclude that the sale of PBI was actually a successful transaction: proceeds were collected within nineteen months from the date of making the announcement in Parliament.

But proceeds were in the hands of the government for two weeks only: on 14 October 1987 DES passed on to the Institute of Plant Science Research

⁹⁰HC 218 1988-89, page 11., Q. 1902.

⁹¹HC 218 1988-89, page 4., Questions 1820-1821.

⁹²Departments of Cytogenetics, Molecular Genetics and parts of the Pathology and Physiology Departments remained in public ownership. Source: Plant Breeding Institute: Annual Report 1986., page 23.

⁹³GBP27.15m was paid for NSDO and GBP38.85m for PBI. Source: Appropriation Accounts 1987-88 HC 17-vii 1988-89, Class XII., Vote 13., pages 45 - 46.

("Institute")⁹⁴ the sum of GBP38.85m, plus an *ex gratia* payment of GBP137,000. Why did the department transfer this amount to the Institute ?

As was mentioned above, the Department offered NSDO and a part of PBI together for sale. The two establishments, however, had different legal status. NSDO was an ordinary state-owned body, while PBI was a registered charity. The Memorandum of the charity set forth special rules concerning the disposal of assets.⁹⁵ The point here is that these rules were so drafted that proceeds from the sale of PBI could not possibly be remitted to the Exchequer.

The Department came up with a new privatisation plan in April 1987. The main point was that the trustees of PBI were requested to pass a resolution. This resolution was to provide that proceeds from the sale of PBI should be re-transferred to the Agricultural and Food Research Council ("AFRC")⁹⁶; in turn the Council would undertake to use such funds to further the objectives of PBI. But this plot turned out to be ineffective: the Institute indicated to DES in February 1988 that it could not comply with the 1987 resolution without the express authorisation of the Charity Commission. DES did not take this warning seriously: the department submitted a Supplementary Estimate to Parliament in the same month confirming that the full net proceeds would be remitted to the Exchequer. When a meeting was called in March 1988 the Charity Commissioners expressed some concerns about the feasibility of the proposed transfer. Three months later the Commission informed all the parties that proceeds from the sale of PBI could not be transferred to AFRC; the sum of GBP38.85m belonged to the Institute. DES and AFRC sought legal advice. The Treasury Counsel accepted the findings of the Charity Commission and advised DES not to take the matter to court. Finally, DES and AFRC acknowledged in July 1988 that the Institute should retain GBP38.85m.

The main point of the PBI - saga is that DES prepared unrealistic Estimates twice: both the 1986 and the 1988 Estimates forecasted that full net proceeds should be remitted to the Exchequer. Inaccuracy of the original Estimate may be forgivable: compared with the Department of Trade and Industry, DES had limited privatisation experience. Yet DES was keen to join the league of Departments having a successful privatisation history: thus less experienced civil servants prepared the original Estimate in an enthusiastic mood.

It is the second Estimate which is hard to give an explanation for. As was mentioned above, the Supplementary Estimate was submitted to Parliament in February 1988. By

⁹⁴This Institute took over the remaining functions of PBI.

⁹⁵HC 218 1988-89, page 5., Q. 1827.

⁹⁶AFRC, a Non-Departmental Public Body, was in charge of the financing of NSDO and PBI. It ceased to exist from 1 April 1994. See: Agricultural and Food Research Council: Annual Accounts 1993-94 In: HC 217 1994-95. page 1., point 1.

this time DES knew⁹⁷ that the Treasury might not receive the full net proceeds: DES was also warned in the same month that the said resolution may be ineffective. Thus one may conclude that DES misled Parliament.⁹⁸ DES breached one of the basic rules of privatisation:

... money received for sales should be remitted to the Consolidated Fund rather than to third parties unless there has been a prior approval of Parliament.⁹⁹

The transfer of GBP38.85m to the Institute was not approved; in fact, the Parliament was led to believe that the full net proceeds will be remitted to the Exchequer. It is not for this Chapter to discuss political responsibility; the question here is what legal solutions, if any, could have prevented this debacle.

Charities, trusts and the like are not simple privatisation candidates. The sale of charitable assets must be structured with special care so as to guarantee that charity law constraints will not bar the Treasury from retaining privatisation proceeds. At least three solutions presented themselves in the PBI - case:

- Act of Parliament

The framework of the PBI privatisation could have been set forth under an Act of Parliament. The legislator could have provided that the full net proceeds shall be remitted to the Exchequer.

The legislator is sovereign in Britain; "... there are no legal constraints on its legislative powers".¹⁰⁰ While the sovereignty of Parliament has not been absolute ever since the UK joined the EU, the point remains: the British government need not worry that a British court will declare a privatisation Act invalid.¹⁰¹ As O. Hood Phillips writes, "Once a document is recognised as being an Act of Parliament, no English [British] court can refuse to obey it or question its validity."¹⁰² To quote the celebrated words of Blackstone: "... what the Parliament doth, no authority upon

⁹⁷According to the findings of the Public Account Committee, DES and AFRC recognised as early as 1986 that PBI's actions were constrained by charity law. Source: HC 218 1988-89, page 5., Q. 1826.

⁹⁸The Financial Times, 6 December 1988.

⁹⁹HC 218 1988-89, page v.

¹⁰⁰Cosmo Graham and Tony Prosser: *Privatizing Public Enterprises* (1991), page 38.

¹⁰¹Constitutional Courts in Europe may rule about the constitutionality of Acts. See, for example, [1992] Euro C.L.Y. 1916., and 1924.

¹⁰²O. Hood Phillips' *Constitutional and Administrative Law* (1987), page 49.

earth can undo."¹⁰³ Hence a privatisation Act is an ironcast guarantee that the transaction is legally feasible.

This technique was used successfully in the case of, for example, (a) the Trustee Savings Bank and (b) the English/Welsh water authorities.

(a) TSB

It was the Trustee Savings Bank Act 1985 which rescued TSB from joining the league of less successful transactions. When unhappy depositors tried to challenge the privatisation of TSB, the House of Lords ruled that

The Act of 1985 privatised the statutory trustee savings banks and Parliament decided to present their surplus assets amounting, it is said, to GBP800 million to the successor company. Your Lordships are not concerned with the wisdom of this decision.¹⁰⁴

The final comment from Lord Templeman echoes a basic constitutional principle: judges in Britain do not rule about the merit of an Act of Parliament.¹⁰⁵

(b) English and Welsh water industry

Turning to the privatisation of the water companies, the leading case is **Sheffield City Council v. Yorkshire Water Services Ltd. and another and related actions (Ch.D.) [1991] 2 All ER 280**. Seventeen local authorities tried to block the sale of water companies; they argued that

... the water authority held the legal interest in the property transferred [pursuant to the Local Authorities (England) (Property etc.) Order 1973] subject to a power to use it for water purposes but otherwise in trust for the plaintiffs beneficially.¹⁰⁶

The court ruled that the plaintiffs' construction was not correct. Having analysed the Water Acts 1973 and 1989, Sir Nicolas Browne-Wilkinson V-C concluded that the proposed disposal of shares "is not controversial, at least legally."¹⁰⁷ The legislator made the following arrangements:

¹⁰³Quoted by Dicey In: A.V. Dicey: Introduction to the Study of the Law of the Constitution (Liberty Classics, 1982), page 5.

¹⁰⁴**Ross v. Lord Advocate 1986 S.L.T. 603**, per Lord Templeman at 611-D.

¹⁰⁵This point has been analysed in more details in Chapter 3. above.

¹⁰⁶at 292 - B.

¹⁰⁷at 286 - B.

- assets of the water authorities were transferred to newly established limited companies (e.g. Yorkshire Water Services Ltd.);
- all the issued shares of such companies were held by public limited companies (e.g. Yorkshire Water plc.) ; and
- shares in the latter were issued to the public in 1990; thus
- property vested in the water authorities under the Water Act 1973 to discharge certain statutory functions was NOT sold.

The final point here is that the Water Act 1989 shielded water privatisation from legal challenges. Local authorities tried to challenge the validity of the statutory scheme seeking to sell water shares (as opposed to assets); however, the court dismissed the claim in Sheffield.

Thus no legal difficulties may thwart privatisation in the UK, if (i) an Act of Parliament provides for the disposal of certain assets or companies and (ii) the legislation is not in breach of EU law. The EU dimension was especially important in the case of the water industry. The Environment Commissioner in Brussels "threatened to take the British government to the European Court": he believed that the Water Bill was a "deliberate attempt to flout EC law".¹⁰⁸

As far as the PBI - case is concerned, the above discussion comes down to a simple point: had an Act of Parliament been passed to facilitate the sale of PBI the Treasury could have retained privatisation proceeds in full.

- Reorganisation

Assets and activities of PBI could have been split into two bits: (a) departments which were to remain in the public sectors, and (b) departments to be sold; only the former would have retained charitable status after the reorganisation. The Charity Commission would have been requested to authorise this scheme. Hence the privatisation of bit (b) would have been subject to no charity law restrictions.

- Winding up

With hindsight, the Committee of Public Accounts argued that a third technique would also have been available. The main points of this solution may be summarised as follows: (i) PBI trustees should have agreed to wind up PBI; (ii) upon winding up proceeds should have been paid over to the Exchequer; and (iii) a new organisation could have been set up immediately.

Out of the three mentioned methods, the *winding up* solution was unacceptable to DES.¹⁰⁹ The Department was correct; winding up would have been a dubious

¹⁰⁸Peter Saunders and Colin Harris: *Privatization and Popular Capitalism* (1994), page 49.

¹⁰⁹HC 218 1988-89, page 11., Q. 1902.

technique. As far as the other two options are concerned, DES told the Committee that the use of *primary legislation* was not considered;¹¹⁰ and *reorganisation* is not mentioned in the Report. Thus DES correctly ruled out the least practicable solution but did not consider other techniques in detail.

The main point to conclude here is that the privatisation of charity assets may cause "unpleasant surprises"¹¹¹. Due to charity law constraints the Treasury may not retain privatisation proceeds, even though the charity was financed from public money. Special arrangements are necessary to secure that charity law will not upset privatisation strategy. Simple legal tricks (like the 1987 resolution) may fall in the 'charitable trap'.

4.4 Trust ports

The moral from the Plant Breeding Institute - saga was that the disposal of charity assets might not be completed successfully without a privatisation statute. It was also mentioned above that an Act of Parliament may render such hurdles harmless (TSB privatisation). This Part will argue that legislation is a necessary but not sufficient condition for successful disposal.

Trust ports were not convenient privatisation candidates: strictly speaking, these ports were not state-owned.¹¹² To avoid privatisation debacles, the Ports Act 1991 [hereinafter: 1991 Act] was passed. The main provisions of the 1991 Act may be summarised as follows:

The Act enabled the trust ports to set up companies¹¹³ and to transfer to those companies property, rights, liabilities and functions of the port authorities (Transfer Scheme). Subject to the approval of the Secretary of State, port authorities had the right to sell shares in the newly created companies voluntarily. The relevant port authorities were responsible for managing the transaction. The 1991 Act provided that a 50% levy shall be charged on net proceeds after deducting allowable expenses (Statutory Levy). After the sale of shares and the payment of the Statutory Levy to the government, port authorities were to be dissolved.

¹¹⁰HC 218 1988-89, page 11., Q. 1902.

¹¹¹A Treasury Officer of Account used this term when he was examined by the Committee. Source: HC 218 1988-89, page 3., Q. 1181.

¹¹²The Financial Times, 14 January 1992.

¹¹³It is interesting to note that the National Ports Council ruled out the idea of converting trust ports into ordinary companies in 1972. Source: National Ports Council: Reconstitution of Major Trust Ports. Proposal for Discussion (1972), page 4.

The diagrammatic presentation of the relevant provisions of the 1991 Act would be the following:

Step 1	Port Authority (PA) set up NewCo
Step 2	Property, rights etc. of PA transferred to NewCo
Step 3	PA offer NewCo shares for sale
Step 4	PA collect proceeds
Step 5	After the deduction of expenses, Statutory Levy paid to Department
Step 6	PA dissolved

TABLE 8.: Ports Act 1991

Two peculiarities should be highlighted here:

(i) Port Authorities in charge of privatisation

Port Authorities (as opposed to the Department of Transport) managed the sale of trust ports; the authorities "sold themselves".¹¹⁴ Port authorities submitted transfer schemes to the relevant Ministers and subsequently disposed of their holdings in the successor companies.¹¹⁵ While these powers were subject to ministerial approval¹¹⁶, the point is that the authorities "were responsible for all aspects of the sale".¹¹⁷

(ii) No proceeds to the government

Net proceeds were to be paid to the authorities, being the legal owners of the successor companies. The government was entitled to a statutory levy which was due to be paid into the Consolidated Fund.¹¹⁸ A two-step procedure was introduced for the collection of levy: (a) The Department of Transport was to serve on each port authority a notice of assessment; and (b) The relevant authorities were to pay the levy within three months of the date of disposal or within 30 days from the date of the notice, if that period ends later.¹¹⁹

What happened to the rump of privatisation proceeds ?

¹¹⁴Section 4 of the Ports Act 1991. and Committee of Public Accounts. Department of Transport: The First Sales of Trust Ports HC 225-i 1993-94 [hereinafter: HC 225-i 1993-94], page 10., Q. 165.

¹¹⁵Sections 4 and 9 of the Ports Act 1991.

¹¹⁶Section 5 of the Ports Act 1991.

¹¹⁷Alfred J. Baird: Privatisation of United Kingdom Trust Ports (1995), page 6.

¹¹⁸Section 16(5) of the Ports Act 1991.

¹¹⁹Section 14(2) of the Ports Act 1991. and also: National Audit Office Department of Transport: The First Sales of Trust Ports HC 896 1992-93, page 12., point 3.4.

The National Audit Office reported that the remainder of the proceeds was passed on to the successor company, "and hence returned to the purchaser."¹²⁰ While this statement may be correct in a political sense, it is not accurate legally. It is a basic principle of British company law that "... the corporation is a legal entity distinct from its members."¹²¹ When the port authorities were dissolved under Section 7 of the 1991 Act, the balance of proceeds was transferred to the successor companies and not to the investors. Bids reflected this "somewhat odd"¹²² procedure: the purchasers offered more than the real value of the ports on the understanding that a portion of the price will be returned to the successor companies. Although trust ports were established locally to foster sea-born trade from certain British ports, local areas ended with nothing after privatisation. Proceeds were divided between the government and successor companies; it is unfortunate that those who promoted and established trust ports received nothing.

Five port authorities (Tees and Hartlepool, Clyde, Forth, Medway and the Port of London) decided to privatise their ports voluntarily. These were the most profitable trust ports in the UK¹²³ and they accounted for around 30% of traffic throughput at major UK ports¹²⁴:

Name of port	% of traffic
London	9.4
Forth	8.6
Tees and Hartlepool	8.4
Medways	2.6
Clyde	1.4
Total	30.4

TABLE 9.: Trust ports

Steps 1. - 4. of the privatisation timetable were completed with unprecedented speed¹²⁵: both the Department and the five port authorities wanted to finish this project before the forthcoming general election. Four of them opted for trade sale,

¹²⁰HC 896 1992-93, page 12., point 3.1. and also: Alfred J. Baird: Privatisation of United Kingdom Trust Ports (1995), page 7.

¹²¹Gower's Principles of Modern Company Law (1992), page 85.

¹²²HC 225-i 1993-94, page 10., Q. 100.

¹²³Alfred J. Baird: Privatisation of Trust Ports in the United Kingdom: Review and Analysis of the First Sales In: Transport Policy Vol. 2(2), 135 - 143., page 136.

¹²⁴Source: Department of Transport. In: Memorandum submitted to: House of Commons: Scottish Affairs Committee: The Removal of Tariff Rebate Subsidy on Northern Isles Freight. HC 1995 - 1996 229-I.

¹²⁵Alfred J. Baird: Privatisation of United Kingdom Trust Ports (1995), page 12.

while Forth Ports plc. was floated. Gross proceeds of some GBP380m were paid to the port authorities by March 1992.¹²⁶

Difficulties began when the Department tried to collect the Statutory Levy (Step 5). According to the National Audit Office, the port authorities did not pay the full amount of levy until March 1993.¹²⁷ The government lost GBP4.5m interest (based upon simple interest at Treasury bill rates) for the six months to December 1992 on uncollected levies.¹²⁸ Under the 1991 Act interest is chargeable on levy not paid by the due date¹²⁹; what was the due date here? As was mentioned above, the 1991 Act set two possible dates: (i) within three months of the date of disposals or (ii) within 30 days from the date of the notice, if this ends later. Thus the due date should have been June 1992 (see point (i) above). But the collection of levy was delayed; the Department did not issue the notices until February 1993.¹³⁰ Thus the deadline was fixed in accordance with point (ii), i.e. within 30 days from the date of notice.

According to the findings of the National Audit Office, the following two issues may be blamed for the delay:

(i) Private Bills

The Department and two authorities had some disagreement about certain expenses in connection with Private Bills. These Bills were promoted before the passage of the 1991 Act; the Department and the relevant authorities did not agree whether such expenses might be deducted from the levy or not.¹³¹

(ii) VAT refund

The amount of recoverable Value Added Tax was not established for some time. The point here was that unrecoverable VAT was treated as allowable costs and as such was deductible from the gross proceeds.¹³² The total amount in dispute was some GBP1.6m.¹³³

¹²⁶HC 896 1992-93, page 1., point 1.

¹²⁷HC 896 1992-93, page 2., point (b).

¹²⁸HC 896 1992-93, page 12., point 3.9. Please note that GBP4.5m is the interest for the first six months; it is not clear why the National Audit Office did not calculate the amount of interest for the entire period (i.e. March 1992 - March 1993). According to the calculation of Richard Page Esq. (Committee of Public Accounts), the total amount of interest was "approaching GBP10m". Source: HC 225-i 1993-94, page 13., Q. 151.

¹²⁹Section 14(4) of the Ports Act 1991.

¹³⁰HC 896 1992-93, page 12., point 3.6.

¹³¹HC 896 1992-93, page 12., point 3.7.

¹³²HC 896 1992-93, page 12., point 3.8.

¹³³HC 896 1992-93, page 12., point 3.6.

Hence the Treasury lost some GBP10m on interest while the Department of Transport was resolving fictitious disagreements with the port authorities. One may argue that the proper course of action would have been as follows:

- (i) The Department should have tried to collect the duty from those authorities which had not promoted Private Bills.
- (ii) Disputes concerning VAT should have been ignored in deciding whether to serve notices or not. The VAT disputes were irrelevant as far as the payment of statutory levy was concerned. Anyway, the amount at stake (GBP1.6m) was trifling compared to the principal amount of levies (GBP169m).

The Department eventually conceded that Private Bill expenses were allowable¹³⁴, while an additional GBP300,000 of levy was collected from the disputed amount of VAT.¹³⁵ The National Audit Office commented that "the costs of delay in the collection of the levy were large in comparison with the disputed amounts".¹³⁶

No special accountancy skill is required to conclude that the Department did not act with much commercial grasp here. No reasonable business(wo)man would risk to lose millions of pounds on interest in order to collect some GBP300,000. If those privatising the trust ports had been in private practice, they would have lost their jobs. What alternative action could have been taken to collect the Statutory Levy promptly?

Solution number 1. -
Contract

When the parties noticed that the disagreements mentioned above might delay the collection of levy, the Department and the relevant port authorities could have agreed in a contract that

- port authorities will use their best endeavour to pay statutory levy within three months¹³⁷ from the date of the contract;
- if the levy is not settled within that time limit, then either party may appeal to an arbitration tribunal so as to get the amount of levy payable determined. The award would be final and enforceable against the port authorities.

¹³⁴HC 225 1993-94, page ix., point 18.

¹³⁵HC 896 1992-93, page 12., point 3.9.

¹³⁶HC 896 1992-93, page 13., point 3.10.

¹³⁷As was mentioned above, Section 14 of the Ports Act 1991 also allowed a three month period for the payment of levy.

This contract would have been valid and binding under British constitutional law. De Smith's *Judicial Review of Administrative Action* writes that if a public body enters into a contract

... the same principles of private law apply as those which govern similar transactions between private corporations, though if in making a contract a public body acts in an arbitrary or unreasonable manner, or exceeds its statutory powers, its decision may be subject to judicial review.¹³⁸

The proposed contract would not have been arbitrary, unreasonable, or ultra vires; hence the contractual solution could have worked. Yet it is doubtful whether the authorities were willing to sign such a contract. After the sale of the successor companies, the port authorities were more interested in reducing the level of Statutory Levy than in paying the money to the Department.

Solution number 2. -
Administrative action

Had the port authorities refused to consent to Solution number 1., the Minister should have served a notice of assessment straightaway. The legislation does not provide that such notice may not be issued without the consent of the relevant port authorities. Once the notice is served it is for the port authorities to challenge the validity of the assessment. Although the Department might not have obtained a final judgement for some time, the court could have awarded interest on unpaid levy under Section 14(4) of the Ports Act 1991. The port authorities perhaps would have been less fastidious about the costs of Private Bills and VAT refunds, had they been liable to pay interest on GBP114.6m¹³⁹.

But the Department considered neither of these solutions; they advocated a third option.

Solution number 3. -
'Provisional' notice

The Department intended to issue 'provisional' notices of assessment "in order that they might receive the undisputed portions of levy."¹⁴⁰ Yet the internal legal unit of the Department concluded that this action would be impossible under the 1991 Act. The Department summarised its understanding of the law as follows:

¹³⁸de Smith, Woolf & Jowell: *Judicial Review of Administrative Action* (1995), page 173.

¹³⁹Total amount of levy due: GBP169m minus GBP54.4m (levy paid by Forth Ports) = GBP114.6m.

¹⁴⁰HC 896 1992-93, page 13, point 3.10.

What the Act says is that the Secretary of State shall make an assessment, one only, of the amount due in levy. . . . It would in principle have been open to the Department to make an assessment which was the amount already agreed and not in dispute. The Department would then have had no powers to demand any further money from the port because of the structure of the legislation.¹⁴¹

The Department acted on the understanding that (i) they "had only one shot"¹⁴² and (ii) even that shot may not be fired without the agreement of the port authorities. As far as point (i) is concerned, the Committee of Public Accounts accepted the 'one shot assessment' view and urged the Department to secure amending legislation.¹⁴³ But Point (ii) was a total fallacy: as was mentioned above (Solution number 2.), the 1991 Act does not stipulate that the Department and the port authorities must agree on the amount of levy. It is remarkable then that neither the National Audit Office nor the Committee of Public Accounts discussed this issue further.

The point here is that it would not have been *ultra vires* for the Department to serve notices the amount of which was in dispute. Had the port authorities been unhappy with the Statutory Levy, then they could have applied for judicial review. But, and this is the main point, the Department refrained from serving notices; civil servants preferred negotiations with the port authorities to taking the matter to court. It was argued in Chapter 1. above that, so far as the regulation of utilities is concerned, legalism has no particularly strong tradition in Britain: 'Negotiate and do not litigate' is the golden rule. While this is a commendable approach usually, the first sale of trust ports shows that the policy of negotiation has its own limits: in this case too much negotiation cost some GBP10m for the Treasury.

This discussion of the 'maximizing revenue' objective may be summarised then as follows:

- British Coal

The government undertook to pay for (i) water pollution until 2000, and (ii) subsidence in unlicensed regions. New mine operators took on subsidence claims in their licensed areas only. The total value of **liabilities** assumed by the government will exceed privatisation proceeds (GBP1bn).

- British Energy

The government is responsible for the decommissioning of MAGNOX stations; Magnox Electric plc. was retained in the public sector. The decommissioning of

¹⁴¹HC 225-i 1993-94, page 12., Q. 140.

¹⁴²HC 225-i 1993-94, page 14., Q. 167.

¹⁴³HC 225 1993-94, page x., point 32.

British Energy stations will not start until 2006 the earliest. Thus the bulk of nuclear **liabilities** remained in the public sector. The government collected GBP1.4bn from the sale of British Energy plc.; but will have to spend some GBP8bn on decommissioning MAGNOX stations.

- Plant Breeding Institute

The DES did not consider the legal implications of **charity status** before submitting an Estimate to Parliament. Having noticed that proceeds might not be transferred to the Treasury, the department and their advisers tried to contrive an alternative procedure: PBI trustees were 'requested' to pass a resolution. This privatisation plan fell in the 'charitable trap' unfortunately; the Treasury lost GBP38.85m.

- Trust ports

Statutory Levy of GBP114.6m remained uncollected for almost a year in this transaction. The principal reason for the delay was mismanagement. The department delayed the issuing of notices on dubious grounds. Had the notices been served on time, the port authorities would have been liable to pay interest on unpaid levy. **Mismanagement** cost the Treasury GBP10m.

The four disposals mentioned above do not satisfy the 'maximizing revenue' objective. The Treasury (i) did not collect privatisation proceeds in the case of PBI and the Trust Ports; or (ii) may spend more on future liability claims than the total amount of proceeds remitted to the Treasury (British Coal, British Energy plc.). Thus the 'maximizing revenue' objective was not achieved in the case of less successful transactions: whatever the business value of the four companies mentioned above was, the Treasury could have collected higher privatisation proceeds from their privatisation.

Part II.

The remaining two objectives

There is an underlying reason for discussing the 'extending share ownership' and the 'improving economic performance' objectives under one heading: statistics. As a main rule, modern statistics never prove anything. Privatisation statistics would be a perfect example. Official statistics seem to show that utility privatisation (a) widened share ownership and (b) improved economic performance in Britain.

Cento Veljanovski refers to a number of statistical surveys conducted by bodies like MORI, National Opinion Polls and the London Stock Exchange and concludes that

... the evidence is clear that as a direct result of privatisation individual share ownership has doubled if not trebled.¹⁴⁴

John Moore writes in an article praising the achievements of privatisation that

The ultimate that people of all kinds have bought shares in British Gas, British Telecom, British Airways - in all of the 46 major companies privatized in the UK to date. . . . And the proportion of individual citizens holding shares directly has risen from barely 1 in 14 to 1 in 4. Close to 11 million people in the UK now own shares directly - that is, not through a pension fund or unit trust. We wish the number were higher, . . .¹⁴⁵

Finally, Sir George Young Bt MP, Financial Secretary to the Treasury told the World Privatisation Conference in 1995 that

The number of share-owners in the UK has risen to some 10 million three times the number in 1979. . . . [in connection with the flotation of National Power and PowerGen] The financial services industry generated over GBP3.25 billion of retail demand from more than a million people - an excellent performance on which I congratulate them. More than a quarter of existing shareholders increased their holdings and over 800,000 people became shareholders in companies.¹⁴⁶

The three sources quoted above suggest that the government achieved the 'maximizing share ownership' and 'improving economic performance' objectives: why would one analyse these points further?

Two reasons may be mentioned here:

(1) As a rule, one should be rather careful when reading statistics on privatisation. Bryan Hurl gives the following example:

If I turn to an academic journal (*Fiscal Studies*) to check the gains and losses of the franchising of local authority services, I read that the cost savings are in the region of 20 per cent. This looks convincing, a supportive fact to include in this book. No sooner have I decided on this than the next issue of the same journal carries a refutation by another group of academics, who proceed to demolish the basis of the first article and then call into question the reliability of the figures

¹⁴⁴Cento Veljanovski: *Selling the State* (1987), pages 102 - 103.

¹⁴⁵John Moore: *British Privatisation: Taking Capitalism to the People* In: Her Majesty's Treasury Guide to the UK Privatisation Programme (August 1995), page 76.

¹⁴⁶Sir George Young Bt MP: Speech to World Privatisation Conference IN: HM Treasury: Her Majesty's Treasury Guide to the UK Privatisation Programme (HMSO, August 1995), page 80.

which looked so convincing. The virtues and defects of privatisation are, indeed, to be found in the eye of the beholder.¹⁴⁷

To sum up, it is an open question how reliable statistics on privatisation are. As a rule, political standing seems to 'colour' statistics on the performance of privatised utilities: having analysed the same set of statistics two beholders might come to diametrically opposing conclusions. For example, the Centre for Policy Studies, established by Baroness Margaret Thatcher, Lord Joseph and John Major, commissioned a survey about the economic performance of privatised companies in 1996 (NERA: The Performance of Privatised Industries). The Centre attached a paper to every copy of the NERA report arguing that on the statistical evidence set forth in the report ". . . privatisation must be judged an outstanding success."¹⁴⁸

A financial advisory firm, Ernst & Young, **disagrees**. A special report about the UK privatisation programme concludes that

Unfortunately, it is difficult to prove that the theory [i.e. privatisation must guarantee greater efficiency] works in practice.¹⁴⁹

But Brian McBeth **agrees** with the Centre for Policy Studies: he argues that "In general privatisation has improved economic efficiency."¹⁵⁰

Simon Jenkins **dissents**: he points out that by the mid-1990s

'total factor productivity' had risen in all industries while prices had fallen. . . . Non-privatized corporations such as the Post Office and British Rail [Note: Sold after the publication of Jenkin's book] had also seen big advances in productivity over these years.¹⁵¹

To conclude, statistics do not help to decide whether privatisation has improved economic performance or not: the number of views is limited only by the number of 'beholders'.

¹⁴⁷Bryan Hurl: Privatization and the Public Sector (1988), page 87.

¹⁴⁸Centre for Policy Studies: Privatisation and its Effect on the Exchequer. Profit or Loss (1996), page 8.

¹⁴⁹Ernst & Young: Privatisation in the UK (1994), page 24.

¹⁵⁰Brian McBeth: Privatisation. A Strategic Report (1996), page 10.

¹⁵¹Simon Jenkins: Accountable to None (1995), page 39.

(2) Collins Cobuild English Language Dictionary explains 'statistic, statistics' as follows:

Statistics are facts which are obtained from analysing information expressed in numbers, . . .¹⁵²

But some points may not be 'expressed in numbers'. For example, so far as 'the widening share ownership' objective is concerned, the following issues should be remembered when analysing official statistics:

It was argued in Chapter 2. that, as far as corporate governance is concerned, shareholding does not really matter: the ultimate question is who keeps the board under control. As was pointed out above, residual government shares as an instrument of government interference did not work in practice. It was irrelevant how many shares were publicly owned after privatisation; the real question was whether the boards of privatised companies were packed with government nominees. If not, the government could not control the management of partially privatised companies irrespective of the percentage of residual shares held. If the biggest shareholder after the flotations could not influence the running of privatised companies, how influential are the millions of 'Sids' holding a tiny number of shares each? Three examples should be mentioned here:

(a) Sid outraged

The salary increases executives of privatised utilities awarded to themselves received much publicity in the press. The best example here is British Gas plc.: the total remuneration for Mr. Cedric Brown, chief executive, was increased by 71 per cent from GBP287,765 to GBP492,602 in 1995.¹⁵³ Small shareholders were outraged and called for directors to 'revise their executive pay policy in line with best practice.' It was the Prime Minister who advised small shareholders on this matter: The Financial Times reported John Major saying that "if British Gas shareholders were unhappy about the chief executive's salary rise they should go along to the annual meeting and complain."¹⁵⁴ And so did they: over 4,000 shareholders attended the Annual General Meeting on 31 May 1995. Yet British Gas defeated the shareholders' revolt: 50% of the company's shares were voted¹⁵⁵, but small shareholders accounted for around 20% of BG shares.¹⁵⁶ Votes from institutional

¹⁵²Collins Cobuild: English Language Dictionary (1990), page 1425.

¹⁵³The Financial Times, 18 May 1995.

¹⁵⁴The Financial Times, 27 May 1995.

¹⁵⁵The Financial Times, 1 June 1995.

¹⁵⁶The Financial Times, 13 May 1995.

investors carried the day. The point here is that small shareholders are not "as effective as the institutions in uncovering managerial weaknesses and forcing change."¹⁵⁷

(b) Sid ignored

More recently, the Chief Executive of United Utilities plc., a water and electricity utility (see Chapter 5. above), has been warned that 'shareholders' are not happy with the performance of the company.¹⁵⁸ What did he do ? He went out of his way to assuage the biggest shareholders; he did not approach the millions of 'Sid'. Why ? Small shareholders have no influence over the board of United Utilities plc. Thus a Chief Executive does not mind what 'Sid' thinks about her/his appointment: it is the vote of institutional investment which really matters.

(c) Sid missing

Peter Saunders and Colin Harris interviewed fifty-nine shareholders who purchased water company shares at privatisation. According to the findings of Saunders and Harris, approximately one shareholder attended the first Annual General Meeting of Southern Water for every 240 who stayed away.¹⁵⁹ And Southern Water is not a one-off example: according to The Financial Times, 614 shareholders attended British Gas's Annual General Meeting in 1994.¹⁶⁰ Why does Sid not attend company meetings ? The economic analysis of law would offer the following answer: the individual cost to Sid of "obtaining information and attending meetings to vote intelligently is often higher than the expected individual return."¹⁶¹

Having considered the three points mentioned above, one may be tempted to refer to Sid as a debenture- (as opposed to share-) holder: (s)he invested some money at privatisation and earns a higher-than-expected return on her/his investment. Richard Posner correctly notes that

The typical shareholder . . . is not knowledgeable about the business of the firm, does not derive an important part of his livelihood from it, and neither expects nor has an incentive to participate in its management. He is a passive investor and, because of the liquidity of

¹⁵⁷Dennis Swann: *The Retreat of the State* (1988), page 305.

¹⁵⁸The Sunday Times, 10 August 1997, Section 3., page 1.

¹⁵⁹Peter Saunders and Colin Harris: *Privatization and Popular Capitalism* (1994), page 153.

¹⁶⁰The Financial Times, 18 May 1995.

¹⁶¹Benito Arrunada and Candido Paz-Ares: *The Conversion of Ordinary Shares into Nonvoting Shares In: International Review of Law and Economics* 15: 351 - 372, 1995., at 354.

his interest, has only a casual and often transitory relationship with the firm. His interest, like that of a creditor, is a financial rather than managerial interest.¹⁶²

The majority of small shareholders would not object to this interpretation. A survey by Peter Saunders and Colin Harris revealed that around 27% of shareholders interviewed regarded shares "as a long-term investment for themselves or their families." For this group "the opportunity to buy shares was little more than an attractive alternative to leaving cash on deposit with a bank or building society."¹⁶³ Around 80 % of the purchasers of British Telecom shares believed that BT shares were a low-risk investment and "half of them thought that purchase of BT shares was no more risky than putting their money in the building society."¹⁶⁴ Saunders and Harris quote extreme examples:

- (i) Some people bought British Telecom shares under the misapprehension that they would lose their telephone lines if they did not.
- (ii) . . . some people continued to buy shares in the aftermath of the Stock Exchange crash of 1987, apparently oblivious of what had happened.¹⁶⁵

The main point here is that groups of small investors mentioned above are shareholders in law but not in practice: they either see shares as "a safe long-term home for their savings"¹⁶⁶ or do not understand what share ownership is about. All they want is a good rate of return on their money; whether they have rights in (shareholders) or against (debentureholders) privatised companies does not matter. As it turned out, purchasing utility shares at privatisation was an excellent alternative to bank deposits: the millions of Sid made a decent profit. The most recent figures are as follows:¹⁶⁷

¹⁶²Richard A. Posner: *Economic Analysis of Law* (Little, Brown and Company, 1992), page 410.

¹⁶³Peter Saunders and Colin Harris: *op. cit.*, page 155.

¹⁶⁴Peter Saunders and Colin Harris: *op. cit.*, page 156.

¹⁶⁵Peter Saunders and Colin Harris: *op. cit.*, page 155.

¹⁶⁶Peter Saunders and Colin Harris: *op. cit.*, page 162.

¹⁶⁷Memorandum submitted by Peter Vass for the Study of Regulated Industries: The Total Investment Returns (before tax) to Shareholders in Privatised Industries In: House of Commons: Trade and Industry Committee: Energy Regulation HC 50-II 1996-97, Volume II., pages 142 - 144.

'*' means average figure.

Name of Utility Privatised	Real Internal Rate of Return per annum per cent	Dividend Yield per annum per cent	Capital Gain per annum per cent
British Telecom*	10.3	7.3	3
British Gas	11	9	2
RECs*	38.5	15.7	22.7
English generators*	25.2	13.2	12
Scottish companies*	13.5	6.5	7
Water companies*	24.4	11.2	13.2

TABLE 10.: Utility share performance

Thus investors earned a better-than-expected rate of return on their money. An intriguing question may be raised here: Would public utilities have pursued a different dividend policy if no millions of small shareholders would have been waiting for dividend cheques twice per annum? As was mentioned above, a group of small investors subscribed for shares on the understanding that share ownership is an 'attractive alternative' to leaving spare cash on bank accounts. Board members were well aware of the fact that dividends were competing against bank rates; and they also knew that small shareholders would not bother to attend company meetings (see Southern Water - story) *unless* something would outrage them (see British Gas AGM of 1995). The easiest way to avoid shareholders' revolt is to pay out dividends: especially so, if around 25% of investors purchased shares on the understanding that it was a better long-term investment than leaving money with banks. Thus the following principle might help to understand the dividend policy of privatised companies: the higher dividend paid, the less likely that Sid would attend company meetings or would vote her/his shares. Perhaps it was not a coincidence then that the executive emolument - scandal erupted at the British Gas Annual General Meeting. This company had the lowest Real Internal Rate of Return among privatised utilities; Capital Gain per annum was a mere 2 per cent.

To conclude, executives may, and actually do, treat Sid as a debentureholder: if privatised companies pay sufficient dividends to her/him, Sid is unlikely to take an active interest in business decisions. It was also argued above that a group of small shareholders would not disagree with this approach. Sid purchased shares at privatisation so as to earn a good return on her/his money; company management does not interest her/him at all. Would it not be better then to re-classify Sid as a debenture holder? Although (s)he has shareholder rights, (s)he does not exercise those rights (Southern Water); and (s)he cannot outvote institutional investors anyway (British Gas). Perhaps some small shareholders would be happy to trade in voting rights in return for a privileged dividend. The

Spanish example may be adopted in Britain: holders of non-voting shares would be entitled to (i) normal dividend (ii) *plus a fixed return with a minimum of 5% of the share's nominal value.*¹⁶⁸

To sum up points (1) and (2), it is "dangerously naive" to rely on statistics exclusively when analysing the success of utility privatisation. Actually, one need not bother with statistics when analysing the economic consequences of denationalisation in the utilities sector; the next Part will present a 'statistics-free' analysis of the 'improving economic performance' objective.

Part III.

The economic performance objective and reorganisation

It was remarked above that statistics (i) may omit important factors that may not be expressed in numbers and (ii) political standing seems to colour the analysis of statistical data. Thus it might be a good idea to say goodbye to statistics when trying to assess the success of privatisation. So far as (i) maximizing revenue and (ii) extending share ownership objectives are concerned, figures are indispensable: How much money was paid into the Consolidated Fund ? How many shareholders were there after the flotation of the public utilities ? Turning to the last objective, 'improving economic performance', figures may be disregarded IF one were to accept the following assumption: "... it is competition rather than ownership which has the biggest impact on efficiency."¹⁶⁹

Professor David Newbery (Cambridge University) has explained this point as follows:

My thesis is that introducing competition into previously monopolised and regulated network utilities is the key to achieving the full benefits of privatisation. Privatisation is necessary but not sufficient. Regulation is inevitably inefficient. Replacing regulation by competition for network services can increase efficiency.¹⁷⁰

The report from Ernst & Young quoted above makes the same point:

... it has been long held that ownership is not the critical factor but rather whether a firm is subject to the forces of competition in its product markets. Introduce competition where previously there was a monopoly, so the argument runs, and efficiency will look after itself.¹⁷¹

¹⁶⁸Benito Arrunada and Candido Paz-Ares: op. cit.

¹⁶⁹Peter Saunders and Colin Harris: *Privatization and Popular Capitalism* (1994), page 22.

¹⁷⁰David M. Newberry: *Privatisation and Liberalisation of Network Utilities* (1996), page 1.

¹⁷¹Ernst & Young, op. cit., page 24.

Dennis Swann writes in the Conclusion of *The Retreat of the State* that

... changes in the ownership in the absence of competition do not inevitably lead to improvements in performance. Changes of ownership which occur under conditions of competition and particularly those that are accompanied by the creation of competitive conditions, are likely to be beneficial - ...¹⁷²

Thus the main point of the 'competition rather than ownership' philosophy is that privatisation will not increase efficiency unless competition is introduced. Hence an analysis of the 'improving economic performance' objective shall concentrate on competition: it is competition which will improve the economic performance of utilities. If a sector is competitive it is quite likely that its economic performance will be improved; thus the question of 'opening up utilities sector to competition' should be examined below in detail.

As a rule, competition presupposes choice: a utility sector is competitive if, and only if, it is the customer who selects a firm to supply her/his home with telecommunication, electricity, gas and water. Thus a number of competing utilities must be licensed to serve the same market, otherwise the customer would have no choice. Compared with nationalisation, this is a revolutionary idea indeed.

As was mentioned in Chapter 2., the designers of nationalisation did not believe in competition: there were no competing suppliers. As a rule, the telecommunication, electricity and gas industries were statutory monopolies; in addition, the legislator conferred on Post Office and the British Gas Board the *exclusive privilege* of running telecommunication/gas services.¹⁷³ As M. A. Mutton put it, nationalisation "involved unified control and a statutory prohibition on entry to and exit from the industry".¹⁷⁴ Hence the licensing of alternative suppliers was out of the question until the early 1980s.

The pendulum started to swing from the 'one industry - one enterprise' principle in the run-up to privatisation; however the pro-competition policy was facing a practical difficulty. Although the *de iure* monopoly of British Telecom, CEGB/the electricity area boards, and the British Gas Board was abolished in the early 1980s¹⁷⁵, competition was slow to emerge. For example, the Energy Act 1983 introduced the so-called 'Third-party Access' in the natural gas industry¹⁷⁶; yet no independent firm tried to gain access to British Gas pipelines until 1986.¹⁷⁷ It was argued above that without alternative suppliers competition was illusory. Hence the number one priority

¹⁷²Dennis Swann: *The Retreat of the State* (1988), page 302.

¹⁷³Post Office Act 1969; and Gas Act 1972.

¹⁷⁴M.A. Mutton: *The Economics of Regulating Industry* (Basil Blackwell, 1986), page 190.

¹⁷⁵Telecommunications Act 1984; and the Energy Act 1983.

¹⁷⁶Third-party Access is discussed in Chapter 6. below.

¹⁷⁷British Gas plc: Offer for Sale of Ordinary Shares. In: *The Financial Times*, 25 November 1986.

was to find suitable firms which would be willing to challenge the *de facto* monopoly of the newly-privatised utilities.

New competitors were firms (i) which had not been involved in the provision of utility services before ('new-comers'); OR (ii) were established after the reorganisation of the nationalised boards (successor utilities). The licensing of new competitors has been discussed in Chapter 2. above; it is point (ii) which shall be analysed here.

While the term 'reorganisation' is self-explanatory, it may be useful to make some introductory comments here. Reorganisation may be defined as the splitting up of nationalised boards into smaller, independent business divisions. Thus reorganisation is the opposite of 'monopolisation', i.e. when a number of formerly competing units are amalgamated.

As a rule, each utility industry may be sub-divided into a number of operational units. For example, the electric industry consists of (a) generation, (b) transmission and (c) distribution. There are similar divisional lines in the natural gas sector: (a) extraction, (b) transmission and (c) distribution. The internal structure of the water sector looks like as follows: (a) collection and treatment of water; (b) provision of domestic/industrial water supplies; and (c) the collection, treatment and disposal of sewage.¹⁷⁸ The telecommunication sector covers four activities (a) the supply of telecommunication apparatus; (b) the running of telephone networks; the provision (c) of basic telephony services and (d) of Value Added Services (i.e. Internet, sex-lines¹⁷⁹). It should be noted here that the telecommunication business was divided into three main areas in the past.¹⁸⁰ But it may be appropriate to sever Value Added Services, especially Internet, from basic telephony now: the latter is seen as a 'basic right', while the 'obligation to supply' does not extend to the former as of today.

The obvious solution would be if reorganisation were to mirror these divisional lines: activity (a) from (b), while (b) would be separated from (c), and so on. A given business unit may be then de-merged into as many utilities as expedient. As a rule, the number of companies operating in the field of (a) or (b) or (c) is in direct ratio to the competitiveness of the activity concerned: the more competitive a given sub-sector is, the more firms may be licensed to enter that particular piece of the market. For example, a single firm is usually in charge of transmission (activity (b) above) in the electric and gas industries. High voltage/pressure transportation of electricity/gas is a truly natural monopoly; it is questionable whether this segment of the electricity/gas chain will ever be competitive. The UK (National Grid plc.) and Hungarian (MVM Rt.) electric industries are examples. On the other hand, there may be a number of electric/gas distributors (activity (c) above): twelve independent electricity distribution

¹⁷⁸Centre for the Study of Regulated Industries & Price Waterhouse: Regulated Industries: The UK Framework (1996), page 37.

¹⁷⁹See: *Maystart Ltd. v. Director General of Telecommunications (CA)*, LEXIS, 17 February 1994.

¹⁸⁰See, for example, M.A. Mutton, *op. cit.*, page 206.

companies operated in England and Wales after the reorganisation of 1990. And how about the reorganisation of the telecommunication, gas and water boards in Britain? Were activities (a), (b) and (c) separated at privatisation in these sectors?

The short answer is NO. As far as the telecommunication, gas and water industries in Britain are concerned, pre-privatisation reorganisation was an opportunity passed up. British Telecom plc, British Gas plc, and the English and Welsh water companies were NOT reorganised prior to their disposals. As far as competition is concerned, the fact that, with the exception of the electric industry, no public utility was reorganised may not be a problem: in theory, a sector may be competitive even though it has not been restructured. As a rule, new competitors may come from *outside* the boundaries of the nationalised telecommunication, gas and water industries. This is the phenomenon known as liberalisation; it has been discussed in Chapter 2. above. A further point should be added here: if a sector is not reorganised, it is more likely than not that outsiders (i) may not find the legal and regulatory playgrounds attractive; hence (ii) would decide not to compete with the incumbent utility. It was noted above that no independent supplier was seeking 'Third-Party Access' to the British Gas network after the passage of the Energy Act 1983. Similarly, opportunities for competition were limited in the water industry. While companies were allowed to apply for 'inset appointments' to supply 'green field sites' under the Water Act 1989, no applications were reported until 1992; then, as was remarked above, the Competition and Service (Utilities) Act 1992 tried to boost competition further. It was the same Act which reduced the 'monopoly threshold' in the gas sector from 25,000 therms per annum to 2,500 therms. As a result, the number of gas suppliers licensed multiplied and the UK natural gas sector emerged as one of the most competitive markets in Europe. A number of big industrial customers, including the electricity generators, turned their backs on their existing supplier. It was a blow to British Gas; BG had signed long-term 'take-or-pay' contracts. As a result, British Gas was in serious financial troubles by the mid-1990s. The company was reorganised: the transmission unit (BG Transco) was separated from the trading arm. To conclude, liberalisation achieved something privatisation tried to sweep under the carpet: the splitting up of British Gas plc.

Two points should be underlined here:

(1) Spontaneous reorganisation

The designers of the British Gas privatisation project did not envisage that the UK gas market would be fully liberalised by 1998: this company failed to take into account the possibility of competition. The privatisation prospectus did not present a long-term view of the gas industry. It is questionable whether the Treasury and/or British Gas plc. had any ideas as to how the UK gas sector should look like twelve years after the flotation. One may argue that long-term planning was all but ignored in the run up to utility privatisation in Britain. As will be discussed in Chapter 5. below, the structure of the English and Welsh electricity sector was

reorganised *spontaneously* between 1995 and 1996; the expiry of Golden Shares opened the floodgates for predators. Further takeover offers are reported in the electricity sector in 1998: Energy Group (formerly Eastern Group) is subject to two offers.¹⁸¹ The government had no blueprint for the shape of the electric sector beyond year 1995 (i.e. the year when the time-limited Golden Shares were due to expire). The same comments are also correct in the case of the water sector: here the Golden Shares expired in 1994.

To conclude then, the UK government did not have plans for the medium and long term development of privatised utilities. Hence *spontaneous* reorganisations took place in the (i) gas, (ii) electricity, and (iii) water industries. The lack of long-term strategy is especially alarming in the utilities sector. Gas, electricity, and water companies tend to plan for twenty - twenty-five years in advance: it is regrettable that their ex-owner, the state, did not do the same at privatisation.

(2) Reorganisation post-privatisation

It was remarked above that British Gas plc. was restructured some ten years after flotation. Reorganisation *post*-privatisation is problematical. As a rule, reorganisation must precede privatisation. As M.A. Mutton argues,

Once the privatisation has occurred within a specific regulatory framework it then becomes very difficult, if not impossible, to envisage fundamental changes taking place, because if those changes directly aim to intensify competition, the valuation of assets and thence the shares will be correspondingly reduced.¹⁸²

It is easy to see why investors were not particularly happy with the post-privatisation restructuring of British Gas: they subscribed for shares in 1986 on the understanding that this firm would be a quasi-monopoly. Share prices rocket after flotation. The government found buyers for its residual stake at 219^{3/4} p per share in 1990: the share price at privatisation was a mere 130p per share.¹⁸³ What was behind this price hike? Two factors, perhaps: (i) efficiency gains¹⁸⁴ AND (ii) the privilege of being the monopoly supplier of natural gas in Britain. Post-privatisation restructuring has stripped away point (ii): a British Gas operating in a competitive market is a less attractive investment than a British Gas having the monopoly right to sell gas to certain categories of customers. The picture is less rosy today: The Financial Times reported that British Gas shares have been

¹⁸¹The Financial Times, March 14/March 15 1998, Weekend Money, page 4. For details, see: Texas Utilities Company: Cash Offer for the Energy Group plc. (March 1998).

¹⁸²M.A. Mutton, op. cit., page 205.

¹⁸³H.M. Treasury: Her Majesty's Treasury Guide to the UK Privatisation Programme (1995), page 22.

¹⁸⁴Chapter 1., Part II.

underperformed by 19% in April 1998. The shares have been trading at a "near 10% discount to a 'sum of the parts' valuation, whereas many utilities trade at a premium."¹⁸⁵ The final note here is then that share prices will plummet if utilities are reorganised *after* privatisation.

The main points of the above discussion may be summarised as follows: British Gas plc. was cushioned against competition until recently: it was privatised and run for years as a fully integrated, *de facto* monopoly. Yet this structure did not survive the liberalisation of the UK gas market: increased competition after 1992 spawned the reorganisation of British Gas.

Thus there are three liberalised utility sectors today (telecommunication, electricity and gas), out of which two were reorganised pre- or post-privatisation: (i) electricity and (ii) natural gas. The remaining two sectors, telecommunication and water, should be considered in turn below.

Telecommunications

Reorganisation seems to be unnecessary here and this is for two reasons:

- Telecommunication is "the most liberalized of the utilities sector"¹⁸⁶; there were "over 150 licensed public telecommunication operators to whom nearly a thousand licences have been issued" in 1996.¹⁸⁷
- The dominant player, British Telecom plc., is subject to tougher economic regulation than electricity, gas or water companies. For example, the Director General of Telecommunications introduced so-called 'Fair Trading Conditions' into British Telecom's licence in 1996: the Director General may deal with "incidents of conduct which he considers to be anti-competitive" *without* making a formal reference to MMC.¹⁸⁸

Hence the telecommunication sector became competitive without the splitting up of British Telecom plc. into NewCo 1. (development, maintenance and operation of the networks) and NewCo 2. (provision of services).

¹⁸⁵The Financial Times, April 15 1998.

¹⁸⁶Colin Scott: The Juridification of the Regulatory Relations in the UK Utilities Sector (Paper for presentation at LSE-Brick Court Seminar Series, 22 April 1997), page 6.

¹⁸⁷Phillips LJ in *Regina v. Director General of Telecommunications, ex parte British Telecommunications plc.* (QBD), LEXIS, 20 December 1996.

¹⁸⁸*Ibid.*

Water

It is easy to see why restructuring was not on the agenda in the water industry at privatisation. First of all, the supply of water to domestic customers is a liberalised activity in Britain. As a rule, any customer may request any water company to provide a supply of water for domestic purposes. Yet cross-boundary supply is rare: would-be customers must meet the cost of any pipelaying needed.¹⁸⁹ Hence it is not the lack of alternative suppliers, but the purse of customers which limits the scope for cross-boundary competition.

Secondly, there were a relatively large number of firms in this market: 10 water and sewerage companies [WaSCs] and 23 water only companies [WoCs] operated in 1992.¹⁹⁰ While a number of take-overs and mergers took place after the expiry of the Golden Share¹⁹¹, the number of licensees remains high. Thus comparative (yardstick) competition could be introduced without the reorganisation of the WaSCs. To conclude, the provision of water and sewage services to customers is the least competitive among all the utilities. It is unlikely that reorganisation at privatisation would have increased competition in the water industry.

What is the relationship then between reorganisation and increased competition? The following points should be considered to see why it is not easy to answer this question:

- Reorganisation is *not* necessarily a precondition to competition. The British **telecommunication** industry is among the most competitive ones in Europe, even though British Telecom plc. was not reorganised prior to its privatisation.
- Reorganisation may be one of the *consequences* of competition. British Gas plc. was reorganised *after* the introduction of competition: by the time BG was split into smaller business units in 1996/97, a number of alternative gas suppliers operated in Britain. Thus reorganisation *followed* competition in the UK **gas** sector.
- Reorganisation may *not* render certain industries more competitive. The reorganisation of the English/Welsh **water** industry would have been a futile attempt to introduce competition. It is doubtful whether the water sector will be competitive in the foreseeable future.

¹⁸⁹OFWAT: Increasing Competition in the Water Industry, Information Note No. 10, as revised, HMSO (1996).

¹⁹⁰OFWAT: Issues Involved in Regulation of Privatised Water Utilities, HMSO, (1992), page 10., point 53.

¹⁹¹See Chapter 5. for details.

- This is not to say, however, that reorganisation is of secondary importance. The restructuring of the UK **electric** industry *was* a milestone in the history of competitive utility services. It was the restructuring of 1990 which paved the way for full competition in the electricity supply industry.

The conclusion here is that a discussion about 'restructuring' may not explain satisfactorily why certain industries are competitive and others are not. A further point should be taken into account to understand the development of competition in the UK utility services; and it is **liberalisation**.

Four options are available here. The first two are simple enough: (a) fierce competition will follow if a sector is **both** restructured and liberalised; (b) there will be no competition if an industry is **neither** restructured nor liberalised. It is more difficult to see whether competition will develop if (c) an industry is restructured but not liberalised and (d) liberalised but not restructured. The Hungarian and British natural gas industries are examples here. The former was restructured but not liberalised in 1991 (see Chapter 6.); no new supplier was licensed until 1996. The British gas sector was liberalised after the passage of the Competition and Services (Utilities) Act 1992; yet no restructuring took place until 1996-97.

Which one is more competitive ? Competition was negligible in Hungary between 1991 - 1996: as will be explained in Chapter 6., the regional gas distribution companies were *de facto* monopolies. As far as Britain is concerned, the main point is that it was increased competition which led to the restructuring of British Gas plc; details have been discussed above.

The final point here is then that liberalisation is essential to competition, while restructuring is not. The following examples support this statement:

- **British telecommunication and gas sectors**

If a utility sector is liberalised, it may become competitive even though the former nationalised enterprise has not been split up into smaller business units.

- **Hungarian gas industry**

If a sector is restructured but not liberalised competition may not develop. New suppliers should be allowed to challenge the monopoly of the incumbent utilities.

The diagrammatic presentation of these points is as follows:

Reorganisation	Liberalisation	Competition	Example
NO	YES	will develop	British telecommunication
YES	NO	will NOT develop	Hungarian gas
YES	YES	the best option	British electricity
NO	NO	not available	Nationalised sectors

TABLE 11.: Reorganisation and liberalisation

The discussion concerning the 'improving economic performance' objective may be summarised then as follows:

- It is competition, rather than ownership, which improves the efficiency of a privatised company;
- Liberalisation is indispensable to competition in the utilities sector; while restructuring may or may not render an industry more competitive.

thus

- It was liberalisation which improved efficiency in the UK utilities sector; hence privatisation as such did not meet the 'improving economic performance' criteria.

Conclusion

This chapter has tried to assess how successful the British privatisation programme was. The introduction has identified three 'core objectives' of privatisation: (i) maximizing revenue; (ii) extending share ownership; and (iii) improving economic performance. It has been argued above that privatisation did not meet any of these objectives:

- The '**maximizing revenue**' objective was ignored in the case of (a) Plant Breeding Institute, (b) the sale of the trust ports, and (c) the disposal of the coal and the nuclear industries.
- It is dubious whether privatisation extended **share ownership** in Britain. If it did, it is not clear whether small investors are properly to be considered as shareholders or as debenture holders.
- Change of ownership is a necessary but not sufficient condition for improving **economic performance** in the utilities sector. Firms tend to develop towards increased efficiency in a competitive market. Liberalisation opened up the telecommunication, electricity and gas sectors to competition in Britain: and economic performance has improved in the industries mentioned. Thus it was liberalisation (as opposed to privatisation) which improved the economic performance of privatised utilities.

Is it to say that privatisation failed in the UK ? Not, of course. There is little doubt that privatisation was successful in **political** terms. The sale of state-owned companies was a characteristic feature of the neo-conservative policy which served the Tory party well between 1979 and November 1990¹⁹². To retain power for almost two decades in Britain is an outstanding performance indeed. Thus, so far as politics is concerned, privatisation was successful; and it was this political motive which kept the ball rolling. The fact that other objectives, e.g. maximizing revenue, widening share ownership or improving economic performance, were not achieved was all but ignored while the Tory party was in power. Perhaps it is the right time to reconsider the success of privatisation taking into account the 'core' objectives mentioned above.

¹⁹²When John Major succeeded to the office of Prime Minister.

Chapter 5.

Five Years after Privatisation - Takeovers in the Electricity Sector

Five is a mysterious number from time immemorial. Five was declared to be the Supreme Ultimate in ancient China. According to a legend, Fu Hsi (29th century BC) discovered a Magic Square of I Ching trigrams while he was wandering along the bank of the Yellow River:

Keeping still 6	The Yielding 1	The Arousing 8
The Abysmal 7	5	The Clear 3
The Gentle 2	The Firm 9	The Joyous 4

TABLE 12.: The Yellow-River diagram

The space at the centre of the Yellow River Diagram was given the numerical value of five; this number was "to serve as the fulcrum to all the directions and thereby represents the Supreme Ultimate."¹

Politicians in the 20th century were also obsessed with number five. For example, Lenin advocated the introduction of five-year economic plans in Russia. He argued that a five-year period would be the ideal time scale to test economic policy in practice. All the COMECON countries followed suit after World War II: five year plans were to guide socialist economies towards communism. Yet the idea of five year planning did not disappear entirely after the collapse of the centrally planned economies : it was actually adopted in Britain. Although it is unlikely that advisers to Mrs. Thatcher consulted Lenin's books on economic planning, the regional electricity companies [hereinafter: RECs] were sold on the basis of a five-year plan: (i) the original price formulae were valid for a period of five years; (ii) the Golden Shares in RECs were to expire in the fifth year after the disposals; and (iii) electricity generators and British Coal signed a five year back-to-back coal contract after the flotations. The purpose of this Chapter is to examine what changes have happened in the British electrical industry when the 'five-year plan' ran out.

The structure of this Chapter will be as follows: after a short introduction, Part I. will summarise how the British electricity sector was reorganised between 1995 - 1996; Part II. will analyse the pre-conditions to and the rationale for electricity mergers; and finally Part III. will raise some competition and regulatory law issues.

¹Roy Collins: The Fu Hsi I Ching. The Early Heaven Sequence (1993), page 16.

Introductory comments

Electricity privatisation - the tough project

The most fascinating thing about the sale of RECs is that it actually happened; neither politicians nor engineers were too enthusiastic about electricity privatisation. The most likely reasons for opposing the sale of electric utilities may be summarised as follows:

- Politics

Virtually every household has electricity supply in mainland Britain. Electricity is regarded as a basic necessity today: it was noted in **Green v. Yorkshire Electricity Group Plc. (Ch.D.)**, LEXIS 19 November 1991 that a building is not usable as a dwelling house without electricity. The other main source of domestic energy, natural gas, will never achieve the same penetration rate; remote, low population areas may not be economically connected to the gas distribution network. Hence virtually every voter in England and Wales was a customer of one of the twelve RECs at privatisation. As a main rule, the more voters a given parliamentary decision is likely to affect, the more Members of Parliament will have something to say in connection with that decision. Active political interest is not necessarily a good omen as far as the progress of privatisation is concerned: parliamentary debates, energy sub-committee discussions etc. tend to delay disposals. According to the official data-base of the Office of Parliament, 42 House of Lords papers and 37 Standing Committee papers were published on the Electricity Bill.² Thus the high electricity penetration rate engendered excessive political attention; politics played too large a part in electricity privatisation.

- Regulatory concerns

Unlike the natural gas or the coal industries, electricity "requires a high degree of co-ordination between the production, transmission and distribution elements."³ Two **physical factors** should be emphasised here: (i) Electricity may not be stored economically. Electricity generated must be transmitted into the national grid immediately. (ii) Electricity consumption is not constant. Peak demands may not be satisfied from storage; customers have to be supplied straight from the transmission grid as and when electricity is required. As Andrew Holmes notes, "there can never be a gap between supply and demand. If there is, the light goes out."⁴ Thus generation, transmission, and supply must be synchronised constantly.

²UKOP Stationery Data on CD-ROM (1997).

³Francis McGowan: *The Struggle for Power in Europe: Competition and Regulation in the EC Electricity Industry* (1993), page 2.

⁴Andrew Holmes: *Privatising British Electricity. Restructuring and Resistance* (1992), page 68.

Against the above mentioned political/regulatory background, it is no surprise that electricity privatisation is not universally popular within the EU. France, Greece, Ireland, and Italy seem to prefer centralised electricity systems to liberalisation and re-structuring.⁵ The UK pursued a fundamentally different energy policy after 1990. The old, centralised electricity system was re-structured in England and Wales as follows:

- **Generation** was separated from transmission and distribution (no vertical integration);
- The electricity **area boards** were re-registered as 100% state-owned, independent, Companies Act-like companies;
- The twelve regional electricity distribution companies jointly owned the **transmission unit** (National Grid plc.);
- As was mentioned in Chapter 4., the first round of privatisation did not affect the **nuclear power stations**: they remained state-owned until 1996.

The above model was not introduced in Scotland. The Scottish electricity industry was NOT restructured: the two Scottish companies were privatised as fully integrated utilities. It is one of the 'never answered questions'⁶ of UK privatisation policy why the reorganisation of the Scottish electricity industry was not on the agenda. Why was reorganisation seen as beneficial in England and Wales only?

Potential arguments *against* the introduction of the English-Welsh model might have included factors like (i) the size of the Scottish market; (ii) social obligations in the case of Hydro Electric; and politics was the third reason. The co-existence of two, fundamentally different electricity systems was not a political issue between 1990 (i.e. year of REC privatisation) and 1995 (i.e. expire of Golden Shares in RECs). It was (a) the Scottish Power bid for Manweb and (b) the National Power/PowerGen bids for RECs which brought the 'integrated *versus* non-integrated' issue to the forefront of daily politics in 1995. As will be highlighted under point C./ (2) below, the English generators' bids for RECs were refused on *political* grounds. Perhaps it was not the first occasion when the future shape of the UK electricity industry turned on party politics: it may not be ruled out that political (as opposed to technical, business, or practical) arguments decided against the restructuring of the Scottish electricity system.

The date of the major electricity sales in Britain were as follows:

⁵Eugene D. Cross: Utility Regulation in the European Union (1996), Part 1.

⁶See Conclusion, Point (4).

Name of utility sold	Year
RECs	1990
National Power and PowerGen	1991 and 1995
Scottish Power and Scottish Hydro-Electric	1991
Northern Ireland Electricity	1993
National Grid	1995
First Hydro Company	1995
British Energy	1996

TABLE 13.: Electricity sales in Britain

This Chapter is not concerned with post-privatisation developments in the Northern Ireland electricity sector. The discussion will concentrate on England and Wales, while references will be made to the Scottish companies where appropriate. The reason for focusing on England and Wales is that this area of the UK has experienced the most radical changes over the last eight years: there were no 'revolutionary' post-privatisation developments in Scotland or in Northern Ireland.

Part I.

The "Great RECs Race"⁷

Privatisation is usually the biggest shock in the life of a state-owned company; the electricity industry is an exception to this rule. Just five years after privatisation the English and Welsh electricity sector was in a turmoil: a number of takeover talks were reported in the press and all but two (Yorkshire⁸ and Southern) RECs were taken over by December 1996.

This paper does not intend to give a full historical survey of the Great REC Race⁹; it will concentrate on three aspects of the electricity takeovers, namely A./ Bidders, B./ Types of Bids, and C./ Outcome of Bidding Process.

A./ Bidders

Bidders may be divided into two groups: (i) UK regulated companies and (ii) others. Scottish Power, North West Water, and Welsh Water belong to the former group; while the latter is comprised of Hanson and US utilities (Dominion Resources,

⁷ The Financial Times, 15 February, 1995

⁸ American Electric Power and Yorkshire Electricity were in merger talks in late February 1997. See: The Financial Times, 24 February 1997

⁹ For a detailed analysis see: OXERA: Utility Takeovers (1997).

Entergy, Avon Energy Partners, CalEnergy, Central and South West, and Southern Group).

So far as group (i) is concerned, a theoretical question may be raised. Had price regulation worked 'properly' in Britain, would regulated firms have had spare cash to purchase another utility? In theory, tariffs are supposed to cover REASONABLE (i) operational expenses, (ii) **capital expenditure programmes**, and (iii) a rate of return on capital employed. If UK regulated companies had sufficient funds to finance the Great REC Race, one would start to wonder whether the regulators set the 'right kind' of tariffs: perhaps OFFER (in the case of Scottish Power plc.) and OFWAT (in the case of North West Water plc. and Welsh Water plc.) were too lenient. The taking over of fellow utility companies is certainly beyond the limits of 'reasonable capital expenditure programmes'.

Others may rebut this argument. The fact that UK utilities emerged as predators confirms that price regulation works perfectly well. Scottish Power, North West Water and Welsh Water had sufficient financial resources to acquire other firms because these companies were run *very* efficiently: they cut back costs after privatisation. The issue of cost-saving will be discussed below in Part II. The point here is that it is open to debate whether the fact that UK regulated utilities were predators is the triumph or failure of RPI-X regulation.

Turning to group (ii), the first point to note is that, with the exception of Hanson, all companies here are US-based utilities. The lack of European predators is striking; especially so, if one were to compare the electricity sector with the water industry in the UK. After privatisation French companies purchased a total of eight English water companies.¹⁰ If French utilities were determined to get a stake in the water supply industry, why did Americans only enter the Big REC Race?

(a) The French 'NON'

The French had at least four reasons for not bidding for British electricity companies. First of all, Electricite de France is already a member of the British Pool; the French enterprise sells around 4% of the annual English electricity demand *via* an undersea interconnector.¹¹ It is a market player without being physically present on the British Isles. The recently passed EU Directive on the internal market in electricity¹² opens up generation to competition. Thus EdF need not acquire a distribution company to secure its market position in the UK.

Secondly, the French are not the most adamant supporters of liberalisation in the electricity sector. In France electricity supply is a public service subject to central

¹⁰OXERA: Utility Takeovers (1997), page 5.

¹¹Eugene D. Cross: Utility Regulation in the European Union (1996), page 238.

¹²OJ L No.27, 30.1.97, page 20.

planning.¹³ The full liberalisation of the UK domestic market does not seem to appeal to EdF. One may argue that EdF found the English and Welsh electricity sector too competitive.

Thirdly, a bid from EdF would have been subject to European Community merger rules. As the latest edition of the Practitioner's Guide to the Acquisition of Private Companies in the European Union states, EC Merger Regulation (Regulation 4064/89¹⁴) applies if a transaction is a 'concentration' with a 'Community dimension'.¹⁵ A bid from EdF for any of the RECs would have satisfied both tests: (i) the takeover would have been a concentration; and (ii) the Community dimension, defined by reference to turnover¹⁶, would have been met as well:

- (i) EdF on its own has more than Ecu 5,000m turnover¹⁷ and
- (ii) the turnover of any REC was more than Ecu 250m in 1995.¹⁸

The European Commission is expected to decide within one month of full notification whether the transaction will be cleared or referred to a detailed investigation. The second stage investigation may take up to four months. EdF might have decided not to take part in the Big REC Race so as to avoid a full investigation into its business dealings.

Finally, French utilities were investing in other European countries at the time of the Big REC Race. For example, EdF purchased two electricity distribution companies in Hungary for HUF 24bn¹⁹; and is keen to acquire power stations in Romania, Poland, and Germany (the City of Berlin).

To sum up, the French were not interested in purchasing British electricity suppliers; this lack of interest explains why EdF owns no REC for the time being.

¹³Eugene D. Cross: *Utility Regulation in the European Union* (1996), page 21.

¹⁴OJ L 395/1, 12.30.1989.

¹⁵Maurice Button and Sarah Bolton (eds): *Practitioner's Guide to the Acquisition of Private Companies in the European Union* (1997), page 5, point 5.1.

¹⁶"The combined worldwide turnover of all the 'undertakings concerned' is more than Ecu 5,000m and the EU-wide turnover of each of at least two of the undertakings concerned is more than Ecu 250m, unless each of the undertakings concerned derives two-third of its EU-wide turnover in one and the same Member State." See: Maurice Button and Sarah Bolton (eds): *Practitioner's Guide* op. cit., page 5., point 5.1.

¹⁷EdF turnover in 1995: Ffr 195.8bn.(app. Ecu 29,560m) Source: *Power in Europe*, 8 March 1996, page 11.

¹⁸Source: Electricity Association: *The UK Electricity System* (<http://www.electricity.org.uk>), Distribution and Supply.

¹⁹East European Energy Report, December 1995, page 2.

(b) The American YES

According to OXERA, an Oxford-based research group, US utilities had five principal reasons for purchasing non-US electric companies:

- Lack of opportunities in the USA;
- Liberalisation in the USA;
- Higher returns in the UK;
- Acquiring good management; and
- Springboard into the European market.²⁰

The first two reasons explain why American utilities were keen to invest abroad, while many European countries could have satisfied the last two points: it was the third point then which was truly peculiar to the English and Welsh distribution companies. American investors were well aware of the fact that price regulation in the UK "allows the possibility of earning supernormal profits, whereas US - style rate-on-return regulation does not."²¹ This issue will be analysed further in Part II. below; the main point here is that a number of reasons might have motivated American investors to acquire British electricity companies. But the principal reason was the 'possibility of earning supernormal profits'.

The last issue to be discussed here is why RECs were not bidding for other RECs. As will be mentioned under point B./ below, the electricity companies were cash-rich: they could have financed intra-industry takeover battles. Actually, more than one REC purchased electricity companies abroad: Eastern Group invested in the Czech Republic, and Midlands Electricity tried to acquire a Hungarian distribution company. Why did RECs look abroad ? Two possible reasons may be mentioned:

(i) The electricity area boards were packed with engineers in the era of nationalisation: the electrical industry was run by engineers for engineers.²² Engineers did not know much about the pros and cons of takeovers; the area boards could not be taken over after nationalisation. Not all incumbent board members were removed at privatisation²³, thus engineer-oriented corporate culture lingered on after 1990. The boards of RECs did not have an 'aggressive' background as far as takeovers

²⁰OXERA: *Utility Takeovers* (1997), page 17.

²¹OXERA: *ibid.*

²²C.D. Foster: *Privatization, Public Ownership and the Regulation of Natural Monopoly* (1992), pages 88. and 152.

²³For example, all board members of Hydro-Electric plc. held similar positions with the North of Scotland Hydro-Electric Board. The Production and Engineering Director is an example: he was appointed in 1966. See: *Scottish Hydro-Electric plc. and Scottish Power plc.: Offers for Sale* (1991), page 139.

and mergers were concerned: this is why the RECs were attractive targets but not active bidders themselves.

(ii) There is little doubt that intra-industry bids would have been referred to the MMC. As will be discussed in Part III. below, the outcome of a merger reference cannot be foretold in the UK. Two points should be underlined here: (i) It is hard (if not impossible) to guess "what view the MMC would take"²⁴, i.e. whether the Commission will conclude that a merger will operate against the public interest or not; and (ii) The Secretary of State has discretion whether or not to follow the Commission's recommendations. As a rule, uncertainty increases the opportunity cost of intra-industry takeovers: an REC might never be sure whether its bid for another REC would be blocked or not. Hence an REC might find a foreign target more attractive: the uncertainty mentioned did not exist in connection with acquiring companies in the Czech Republic and/or Hungary. Furthermore, the acquisition of Czech and/or Hungarian utilities is NOT subject to EU merger control: these countries are not members of the European Union as of today. Yet both countries may join the Common Market by 2005: they are already members of the EU electricity network. Thus taking over electric utilities in the Central European region seems to offer the best of both worlds: (a) the acquisition is not subject to EU approval today, BUT (b) the target countries will join the EU in the foreseeable future.

The final point here is then that had the British system of merger control been more predictable²⁵, perhaps some RECs would have been bidding for other RECs.

B./ Hostile or Recommended Bids

It would be naive to suggest that take-over offers came like a bolt from the blue: the RECs were quite attractive takeover targets. The RECs reported steady profits for the first five years after privatisation: on average, a company made an operating profit of GBP120m on an annual turnover of GBP330m from distribution, and another GBP30m profit on a turnover of GBP1,300m from supply.²⁶ Board members were well aware of the fact that the RECs might not defy their fate: with the exception of Manweb (Scottish Power), SWEB (Southern Group) and Northern Electric (Trafalgar House and, later, CalEnergy), all the bids were recommended.

The fact whether a bid was recommended or not did not influence the operation of the competition authorities. On the one hand, recommended bids were blocked (bids

²⁴*Regina v. Director General of Electricity Supply, ex parte Scottish Power plc.* Lexis, 3 February 1997.

²⁵For example, the Electricity Act 1989 could have provided for automatic reference to the MMC under certain circumstances. The lack of automatic reference clause is further discussed under Point 3. of Part III.

²⁶Electricity Association: The UK Electricity System (<http://www.electricity.org.uk>), Distribution and Supply.

by National Power and PowerGen for Southern Electric and Midlands Electric); on the other hand, hostile bids (e.g. CalEnergy's bid for Northern Electric) succeeded without being referred to the MMC.

C./ Outcome

As was mentioned above, ten RECs were taken over by December 1996. But more than ten bids had been launched in the British electricity sector; some takeover attempts did not bear fruit. The Trafalgar bid lapsed, the National Power/PowerGen bids for RECs did not get the green light, and the proposed takeover of National Power was blocked by the government. Unsuccessful bids will be analysed in turn below.

(1) Trafalgar House - Northern Electric

The Great REC Race actually had a bad start: the first bid lapsed after a fierce takeover battle between Trafalgar House and Northern Electric. Adverse circumstances decided against this bid. First of all, the bid was premature; it was launched in December 1994 some three months before the expiry of the Golden Share in the RECs. Strictly speaking Northern was more a potential than a real takeover target at that stage: as will be discussed below, bids were at the mercy of the Golden Share holder until 31 March 1995. Secondly, the bid was based upon a presumption which turned out to be false. Both the bidder and the target company calculated the future financial value of Northern on the basis of the August 1994 distribution price proposal from OFFER. As will be discussed below, this proposal favoured the RECs; thus Northern's management was determined to fight off the Trafalgar bid. The Northern defence package included:

- 507 pence per share cash payment;
- special dividend of GBP165m; and
- a promise to distribute proceeds from the sale of Northern's holding in the National Grid among shareholders.²⁷

The defence documents laid out a buoyant financial position under the proposed new price regime.²⁸ This financial information did not quite correspond to the forecasts upon which the Director General of OFFER prepared his price proposal. When Professor Littlechild looked at "the new evidence associated with the share price increases and the takeover bid for Northern Electric" he decided to reconsider the August 1994 proposal.²⁹ The consequences of this announcement will be discussed in

²⁷The Financial Times, 20 February 1995.

²⁸Martin Brough, Seumas Lobban: Guide to the Economic Regulation of the Electricity Industry (September, 1995), page 13.

²⁹OFFER: The Distribution Price Control: Revised Proposals (July 1995), page 2.

Part II. below; here it is sufficient to remark that, although Trafalgar House did not take over Northern, this bid was an important momentum of the Big REC Race. It was the Trafalgar - Northern takeover battle which led to the revision of the August 1994 distribution price proposal.

(2) National Power and PowerGen bids for RECs

If competition authorities were bound by their previous decisions, then the English generators would be the happy owners of two RECs today. National Power and PowerGen launched their takeover bids for Southern Electric and Midlands Electric respectively *after* the acquisition of Manweb by Scottish Power.

The background to these bids may be summarised as follows: 'vertical integration' was a crucial issue at privatisation. After the winding up of CEGB, generation was to be severed from distribution in England and Wales: as was noted in the Introduction, the two Scottish companies remained vertically integrated. The generators' bid for RECs challenged this institutional structure. The question was whether vertical integration should be permitted in England and Wales or not.

In the case of the Scottish Power - Manweb takeover the Secretary of State answered this question in the affirmative: the bid was not referred to the MMC.³⁰ Hence National Power and PowerGen were led to believe that the same hands-off approach would apply to their bids. The Secretary of State sent the first strange signal on 23 November 1995: both bids were referred to the MMC. The remit of the Commission was as follows:

- to consider whether the situation qualifies for a merger investigation;
- if so, to decide whether it might be expected to operate against the public interest; and
- if it is expected to operate against the public interest, to recommend possible remedies.³¹

The MMC report allayed the generators' fears: the Commission approved the mergers subject to three conditions.³² The Secretary of State was expected to clear the bids. But Ian Lang Esq. had a different agenda; the bids were blocked on 24 April 1996 on the grounds that "the mergers would have adverse impacts on the development of competition in generation and supply, and on the effectiveness of regulation."³³

With hindsight, one may argue that (a) the Scottish Power bid for Manweb and (b) the National Power/PowerGen bids for RECs may be distinguished. As was noted above, Scottish Power was already a vertically integrated company, while the English generators were deliberately excluded from distribution after privatisation. Thus the

³⁰The Financial Times, 18 September 1995.

³¹OXERA: MMC Reports on Power Generators (1997), page 12.

³²Short Circuit. In: The Economist, April 13 1996.

³³Electricity Association: The UK Electricity System (<http://www.electricity.org.uk>) Appendix.

Scottish Power - Manweb merger merely added an extra unit to the already existing distribution business of the Scottish company; the National Power/PowerGen bids would have turned English RECs and generators into vertically integrated utilities.

Yet commentators do not agree with this argument. They claim that concerns over the future of competition was perhaps the least important factor in this case³⁴; the National Power and PowerGen bids fell victim to a power struggle in Westminster. The Financial Times published the following comment as early as September 1995:

It would be undesirable if he [Secretary of State] eventually referred a bid simply because political pressure could not be ignored.³⁵

This is exactly what happened. The government had a majority of one vote in the House of Commons by early 1996; Conservative backbenchers openly opposed the National Power/PowerGen bids. Thus parliamentary mathematics decided against the power companies; when all the votes count the Secretary of State may not enrage backbenchers.

(3) Proposed takeover of National Power

National Power lived a double-life in the Great REC Race; it was both a predator and a target company. Southern Group indicated in early 1996 that it intended to bid for National Power.³⁶ Takeover plans fell through in early May when the government clarified its position on the status of the English generators:

As a result of recent merger activity in the electricity industry, the Government has reviewed its policy on the special shares in the light of the possibility of bids being made for the generators. It has been decided that it should retain the special shares in view of the importance of National Power plc. and PowerGen plc. as independent generating companies operating in a market which is not yet fully competitive. As and when the Government is satisfied that there is adequate competition in the generation and supply markets it will be prepared to consider whether, after consultation with the companies, to redeem the special shares.³⁷

³⁴OXERA: MMC Reports on the Power Generators (1997), pages 19 - 20. and Dr. Kim Howells MP: Approaching Regulation from Westminster (1996), pages 2 - 3.

³⁵The Financial Times, September 18 1995.

³⁶Ken Bailey: A Bid too far? In: [1996] 7 Util LR 134, at 135.

³⁷Press release from the Department of Industry and Trade. Quoted in: Power in Europe, May 3, 1996, page 2.

The general implication of this announcement was that the government will block the takeover of any electric utility in which it holds a Golden Share.³⁸ Hence with the exception of the two remaining independent RECs, no electricity company might be taken over in the UK after May 1996.

The government, however, may change its policy: the Secretary of State may request the generator companies to redeem the Special Share at any time.³⁹ Thus it is up to the government of the day whether National Power and PowerGen will be taken over; and, if yes, when. Uncertainty as to when and how Golden Shares will be activated was discussed in Chapter 2. above. Suffice it to say here that potential bidders would be advised to go and meet the relevant Secretary of State first. Consulting law books and statutes may be a waste of time; it is up to the Secretary of State whether the remaining Golden Shares will be activated or not.

Part II.

Rationale and Conditions

Prior to the analysis of legal and regulatory issues (Part III.), it may be useful to address two preliminary questions: (i) Why were so many predators so keen to acquire RECs ? and (ii) If RECs were ideal takeover candidates, why were no bids launched before December 1994 ?

Question (i) is concerned with the underlying economic reasons for electricity takeovers. It was price regulation which made the RECs attractive target companies. As was mentioned in Chapter 1., Britain opted for the introduction of an 'RPI-X' - style regulation in 1984 (flotation of British Telecom plc.). Compared with other widely used methods of price control (e.g. rate-on-return and sliding scale), this price regime presents the strongest incentives for regulated firms to reduce costs. The point here is that utilities may reap the full benefits of efficiency gains between two price reviews. It was also argued in Chapter 1. that efficiency gains, as opposed to an increase in the number of units sold, are the main source of profit after privatisation. The following tables reinforce that point:

Sales per consumer (average all consumers, all RECs) ⁴⁰			
Year	1993	1994	1995
kWh	10,864	10,680	10,940

TABLE 14.: REC sales

³⁸National Grid Company; National Power; PowerGen; Scottish Power; Scottish Hydro-Electric; Northern Ireland Electricity; and British Energy.

³⁹National Power and PowerGen: Offers for Sale (1991), page 245., point 13.

⁴⁰Source: Digest of UK Energy Statistics (1996), Table 49., page 104.

Operating profit of Eastern Group⁴¹

Year	1993	1994	1995
GBPmillion	186.1	195.2	244.3

TABLE 15.: Eastern Group (1993 - 1995)

Operating profit of Southern Electric⁴²

Year	1993	1994	1995
GBPmillion	191.8	210.7	231.0

TABLE 16.: Southern Electric (1993 - 1995)

Thus operating profit is not in direct ratio to electricity sales; sales dropped in 1994 while operating profit continued to soar.

This is why the RECs were attractive targets for those predators who believed that further cost savings may be achieved in electricity distribution and/or supply. The answer to question (i) is then that efficiency gains were the main drive for mergers in the UK electricity industry.⁴³ US investors could see further scope for efficiency improvement and cost reduction; this is why American offerors were particularly active in the Big REC Race.

Turning to question (ii), the starting point is that potential bidders had presumably been aware of the above discussed peculiarity of UK price regulation since 1990. Nonetheless predators could not launch their bids for some time; the following circumstances precluded takeovers until the Summer of 1995:

A./ Bid proof RECs

RECs could not have been taken over immediately after privatisation: Golden Shares protected the electricity companies from hostile bids and from other 'unpleasant things happening'. The relevant section of Article 10(2) of the Articles of Association of Eastern Group plc.⁴⁴ read as follows:

Notwithstanding any provision in these articles to the contrary, each of the following matters shall be deemed to be a variation of the rights attaching to the Special Share and shall accordingly be effective only with the consent in writing of the Special Shareholder and without such consent shall not be done or caused to be done:-

⁴¹Hanson: Recommended Cash Offer for Eastern Group plc. (1995), page 48., Appendix 3., Part B.

⁴²National Power: Recommended Cash Offer for Southern Electric (1995), page 41., Appendix III.

⁴³Ken Bailey: A bid too far ? In: [1996] 7 Util LR 134.

⁴⁴It is understood that the twelve RECs had a standard set of Articles of Association at privatisation. References in this Chapter are to the Articles of Association of Eastern Group plc.

- (a) the amendment, or removal, or the alteration of the effect of (which, for the avoidance of doubt, shall be taken to include the ratification of any breach of) all or any of the following:-
 - (i) in article 1, the definitions of "the Special Share", the "Special Shareholder" and "recognised person";
 - (ii) this article;
 - (iii) article 40;
- (b) . . .

It was point (a) (iii) (Article 40.) which ruled out the acquisition of any RECs. This Article was concerned with limitations on shareholdings. The main rule here was that no person might directly or indirectly own or control the right to cast on a poll 15 per cent or more of the votes at general meetings.⁴⁵ This Article was to remain in force until 31st March 2000.⁴⁶ Two questions should be discussed here: (i) How was Article 40. supposed to work in practice ? and (ii) What happened to the 31st March 2000 deadline ?

(1) Procedure to enforce limitations on shareholdings

In line with ordinary British company law practice, the share capital of each REC consists of registered (as opposed to bearer) shares. The transfer of shares should be registered in a Share Register as regulated under Section 352 of the Companies Act 1985. Article 40(6) provided that if it appears to the directors that a person holds an interest in shares which carry the right to cast 15% or more of the total votes (Relevant Shares), then the directors shall give a notice to that person (Relevant Person). This notice would set forth two points: (i) it would draw the attention of the addressee to the 'Limitations on shareholdings' section of the Articles; and (ii) would require the Relevant Person to reduce his/her holding to below 15% within 21 days (Required Disposal).

Once a notice has been served the Relevant Person may not attend or vote at any general meeting. However, the third component of shareholder rights, the right to dividend, does not seem to be affected: one may argue then that had an REC declared dividend after the date of the notice, the Relevant Person could have claimed such dividend.

If the Relevant Person fails to comply with the notice, then the directors might sell Relevant Shares; the net proceeds (minus any expenses incurred) would be transferred to the Relevant Person.

⁴⁵Article 40(1).

⁴⁶Article 40(2).

To summarise, directors of the RECs were to ensure that no person controls 15% or more of the votes at general meetings.

(2) Deadline

If the above discussed 'Limitations on shareholdings' rules were to remain in force until 31st March 2000, how could bidders acquire 100% of the issued share capital of ten RECs between July 1995 - December 1996 ?

What should be underlined here is that there was a time gap between (a) the final date for the redemption of Golden Share (March 1995) and (b) the date set forth under Article 40. (March 2000). Out of the two deadlines the former was of special importance, while the latter had no effect upon the timing of the Big REC Race.

So far as the **redemption** point is concerned, the point is that two kinds of Golden Shares were in use in Britain: (a) time limited and (b) non-time limited. The difference between (a) and (b) may be expressed as follows:

- A **time limited** Golden Share will expire *automatically* 'X' years after the initial flotation. As a rule, the value for X was five (5) in Britain. Is it open to debate whether a time limited Golden Share is "an effective way to resolve concerns about the national interest."⁴⁷ A long list of questions may be raised here: Why does 'the national interest' deserve protection between years 1 - 5 only ? What difference does it make whether RECs are taken over in 19X4 or in 19X5 ? If a possible takeover was regarded as a threat to 'national interest' last year and the year before, why could foreign predators acquire the same companies today ? A possible argument *in favour of* time-limited Golden Shares is that the RECs were sold at an undervalue: the offer price was low so as to attract as many small investors as possible. Yet setting low offer prices necessarily implied that big institutional investors found the RECs surprisingly cheap. The question for the government (and its advisors) was how to make sure that the latter group will not take over RECs *immediately* after privatisation. Time-limited Golden Shares were meant to create some distance in time between (i) privatisation and (ii) the prospect of foreign take-overs. The UK government decided to keep US utilities out for five years hoping that RECs would not be too attractive take-over targets after that period: for example, (i) share prices could rocket; (ii) the regulator might 'tighten the reins of power'; and (iii) managers could restructure RECs in a way that foreign predators would not bid for them. But this plan did not quite work out: US utilities snapped up RECs as soon as the Golden Shares expired. Hence the merit of the argument discussed here (i.e. very attractive RECs will be 'less' attractive take-over targets once things settled down in the electricity sector) may be subject to some debate after the 'Big REC Race'. The final point here is

⁴⁷ John Moore: British Privatisation: Taking Capitalism to the People. In: H.M. Treasury: Her Majesty's Treasury Guide to the UK Privatisation Programme (1995), page 71.

that it is fairly difficult to find a good reason for introducing time-limited Golden Shares in the UK electricity sector.

- There is no fixed 'Expiry date' in the case of **non-time limited** Golden Shares. As a rule, the government may redeem such shares at any time. Yet the tendency is that non-time limited Golden Shares do remain in place. The proposed takeover of National Power in 1996, discussed under Part I., C./ (3) above, is an example: the government activated the non-time limited Golden Share to fight off an American predator.

As was noted above, Golden Shares in the RECs were time limited: all of them expired on 31 March 1995. The 31st March 2000 deadline was set forth under Article 40.; as was quoted above, this Article was one of the three Articles which might not be amended, removed, or altered without the consent in writing of the Special Shareholder. After that date the amendment of the "Limitations on shareholdings" article was subject to ordinary company law rules. The diagrammatic presentation of this point would be as follows:

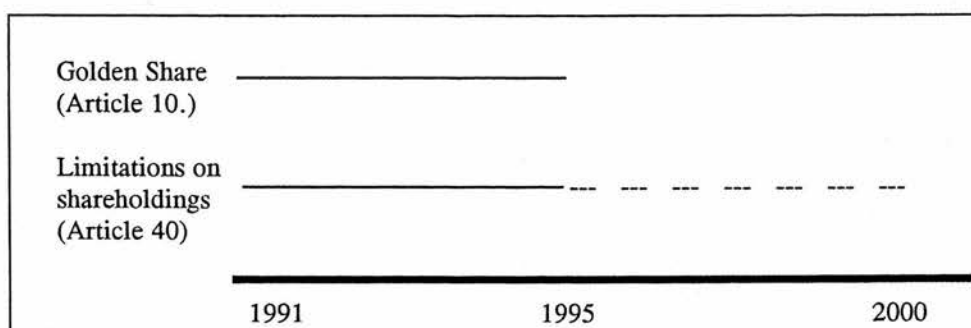


TABLE 17.: Golden Share and limitations on shareholdings

Hence an extraordinary resolution passed at a general meeting after 31 March 1995 might remove the 31st March 2000 deadline from the Articles. Potential target companies might amend Article 40. in order to enable offers to proceed; this is what happened, for example, in the case of the Hanson - Eastern bid.⁴⁸ Thus the 'Limitations on shareholdings' section was amended in 1995, although Article 40. could have remained in force for another five years. One may conclude then that shareholders opened the floodgates to predators: after the expiry of the time limited Golden Shares they voted to remove 'Limitations on shareholdings' section from the Articles.

⁴⁸Maurice Button and Fiona Buxton: A Practitioner's Guide to the City Code on Takeovers and Mergers (1996), page 97., point 3.3.1.

B./ Distribution price review

The Golden Shares expired in each REC on 31 March 1995, however the Big REC Race did not start until the Summer of 1995. Why did potential predators hesitate to launch their bids? Presumably they would have been glad to go ahead as soon as possible, but one condition was missing until July 1995: the new price formula for the period 1996 - 2000.

As was mentioned in the introduction, the English and Welsh electricity sector was privatised on the basis of a five-year plan. The original distribution price formulae were in force for five years after privatisation; thus new formulae were due to be introduced as from 1996. The Director General of OFFER published a consultation paper on the proposed price regime in August 1994. Professor Littlechild's recommendations stunned the twelve distribution companies: the proposed new formulae were lenient. The main elements of the proposal were (i) a one-off 11 - 17% cut in allowed charges and (ii) an RPI-2 price increase per annum.⁴⁹ It was this proposed price regime which induced Trafalgar House to try to acquire Northern Electric as early as December 1994. As was mentioned under Part I., point C./, (1) above, the Northern board did not recommend the bid. The defence document published in February 1995 set out a buoyant financial future for the 1996 - 2000 period: the directors contended that Northern would be a gravy train under the new price regime. The profit forecasts outraged both politicians and consumer councils.

At this stage Professor Littlechild made a move which was, and hopefully will remain, unprecedented in the history of post-privatisation regulation: the Director General announced on 7 March 1995 that he was 'minded' to reconsider the August 1994 proposal. Both the main point and the timing of the announcement were unfortunate:

- Main point

It was argued in Chapter 1. that utility regulation is not 'legalistic' in Britain. As a rule, law is foreign to British utility regulation; negotiation and mutual trust are the key words here. As Anthony Barnett notes, "regulation of utilities is handled day-to-day by close co-ordination between the regulators and the privatised utilities."⁵⁰ Thus Professor Littlechild's announcement did not go down well: The Financial Times quoted investors saying ". . . the statement defies belief. I felt almost as if I had been sent to the lunatic asylum. It says more about the regulator than it does about the RECs. It is a disgrace."⁵¹ Ironically, it was the electricity regulator himself who emphasised the disadvantages of meddling with price reviews in 1992 as follows:

⁴⁹The Financial Times, March 8 1995.

⁵⁰Anthony Barnett: Regulation of the UK Utilities. Prospects to 2000 (1996), page 31.

⁵¹The Financial Times, March 8 1995.

If a Regulator is seen to intervene in the operations of a company, there will be an adverse effect on the incentive to that company to improve its efficiency and reduce costs. What is more, the degree of regulatory risk to which it is subject may be perceived as greater.⁵²

The main point here is that the decision to reconsider the 'botched' price review undermined the regulator's credibility, increased regulatory risk and damaged investors' confidence in the electricity sector.

- Timing

Professor Littlechild announced his decision on the day after the flotation of the residual government stakes in National Power plc. and PowerGen plc. (see: Chapter 3. above). Having purchased back an 8% stake, National Power threatened to take the government to court. Mr. John Baker, chairman of National Power, summarised his company's claim as follows: "The flotation price might have been lower if the market had known what might be going to happen."⁵³ As it turned out, this statement was more a PR exercise than a legal threat - National Power did not start proceedings. Nonetheless, the point remains: the timing of the announcement was unfortunate.

The main point here is that Professor Littlechild's announcement of March 1995 thwarted potential takeovers in the electricity sector. Without the new distribution price formulae potential predators could not calculate the business value of the RECs for the 1996 - 2000 period. The irony of this situation was that the 'botched' price proposal suspended takeover talks in March when the bid-proof status of the RECs was just about to be relinquished.

The new distribution price proposal was ready by 7 July 1995.⁵⁴ Professor Littlechild made the following recommendations: (i) in addition to the 11 - 17% one-off cut in allowed charges, a further cut of 10 - 13% in real terms in 1996; (ii) RPI-3 price increase per annum in real terms up to 2000. Compared to the original proposals, the new price regime was less favourable to the RECs:

⁵²House of Commons. Trade and Industry Committee: Government Observations on the Second Report from the Energy Committee (Session 1991-92) on the Consequences of Electricity Privatisation HC 222 1992-93, Appendix 2: Memorandum submitted by the Director General of Electricity Supply, page xii., point 36.

⁵³The Financial Times, May 17 1995.

⁵⁴OFFER: The Distribution Price Control: Revised Proposals (July 1995).

	August 1994 proposal	July 1995 proposal
Allowed charges	one-off cut of 11 - 17%	11-17 % one-off cut PLUS 10-15% cut in 1996
Price increase	RPI - 2	RPI - 3

TABLE 18.: Two price proposals compared

But the July 1995 proposal did not dismay investors: Southern Group set the ball rolling ten days after the announcement of the new distribution price formulae. Two further bids followed within the next fourteen days.⁵⁵

To summarise, the Director General of OFFER decided to re-review the August 1994 proposals in March 1995. This announcement suspended takeover activity in the electricity sector. The Big REC Race started shortly after the publication of the new price proposals in July 1995.

Part III.

Competition and Regulatory Law Issues

The above discussion has touched upon a number of competition and regulatory law points. The purpose of this Part is to examine the following four issues in more detail: (1) Discretion and politics; (2) The role of the Director General of OFFER; (3) Privatisation legislation reconsidered; and (4) Comparative takeover procedures.

(1) Discretion and politics

If law is a set of firm rules, then there is no such a thing as British law on merger control. Ministerial control over takeovers is fraught with discretionary decisions in Britain; as two prominent practitioners put it, "merger control in the United Kingdom is a regime based on discretion and choice".⁵⁶ An oversimplified description of the statutory framework would be as follows:

- If a proposed merger satisfies certain criteria ("market share test" and/or the "assets test"), then the Secretary of State may refer that merger to the MMC for investigation.
- The MMC's carries out a detailed investigation over a period of usually three or four months.
- If the MMC' report concludes that the merger may be expected to have effects adverse to the public interest, then the Commission should make recommendations as to remedies.

⁵⁵Scottish Power's bid for Manweb on 27 July 1995; and Hanson Group's bid for Eastern Group on 31 July 1995.

⁵⁶Roger J. Finbow and A. Nigel Parr: U.K. Merger Control: Law and Practice (1995), page 10., point 1.014.

- The Secretary of State shall consider the report, but he is not bound to follow the MMC's conclusions or recommendations;
- If the offeror gives undertakings to the Secretary of State, he has discretion whether or not to take steps to enforce such undertakings.⁵⁷

This system of merger control depends upon the action or inaction of the Secretary of State; "the Commission's role is simply advisory."⁵⁸ Hence takeovers may be exposed to political meddling in the UK; especially so if the government of the day has no strong support in the House of Commons. The first bid for an REC was launched on 14 December 1994 (Trafalgar House - Northern Electric) and the last takeover was completed on 24 December 1996 (CalEnergy - Northern Electric); this period turned out to be the last years of the Conservative party in power. As was mentioned in Part I., the government's majority shrank to one in the Commons by the Spring of 1996. Thus the timing of the Big REC Race was unfortunate; the less votes the Conservative party controlled in the Parliament, the more influence party politics had on the decision of the Secretary of State. As Dr. Kim Howells MP (Labour Party) noted, the decision to block the power generators' bid for RECs was 'a side of raw meat' thrown to the European obsessive wing of the Tory party.⁵⁹

The main point here is that electricity mergers were not tested against a long-term, industry-wide strategy; the fate of bids turned on *ad hoc* political considerations. The Secretary of State blocked takeovers so as to secure votes on other issues in the Parliament. Thus the current ownership structure of the British electricity sector emerged without much planning. Professor Cosmo Graham lamented in 1995 as follows:

... it is a matter of regret that there seems to be no institutional means of taking an overview of what is happening in the utilities sector and the public policy implications.⁶⁰

Mr. Ken Bailey makes the same point: when the English and Welsh electricity industry was being restructured in 1995 "no one appeared to have the slightest notion of where it was going."⁶¹

To sum up, the Secretary of State had no blueprint of the future shape of the electricity industry; discretionary power was used to serve short-term political goals. The lack of clear policy framework is especially alarming bearing in mind that long-term, high level co-ordination is a must in the electricity sector.

⁵⁷Mid Kent Holding plc. v. General Utilities (Ch.D.) [1997] 1 W.L.R. 14., at 37-D.

⁵⁸The Stair Memorial Encyclopaedia, Volume 4., para 1276.

⁵⁹Dr. Kim Howells MP: Approaching Regulation from Westminster (1996), pages 2 - 3.

⁶⁰Professor Cosmo Graham: Mergers, Competition Law and Utilities In: [1995] 6 Util LR 136.

⁶¹Ken Bailey: A Bid too far ?In: [1996] 7 Util LR 134, at 135.

(2) Powerless power regulator

If the Secretary of State was the ultimate decision maker and the MMC's role was simply advisory, what was the Director General of OFFER supposed to do ? As far as merger control is concerned, the blunt answer is NOTHING. The Electricity Act 1989 does not contain provisions on mergers involving electricity licensees; thus the Fair Trading Act 1973 applies in the usual way.⁶²

This is not to say, of course, that the Director General of OFFER could sit back during the Big REC Race. He had important statutory duties to perform. For example, he must secure that the merged companies "are able to finance the carrying on of the activities which they are authorised by their licenses to carry on".⁶³ The regulator could, and did, seek modification to the licences⁶⁴: for example, the Director General proposed certain amendments so as to ring fence the physical and financial assets of the licensed business.⁶⁵ But, and this is the main point here, the statutory functions mentioned above are 'general' duties: the Director General of Electricity Supply has NO special powers to deal with mergers in the UK electric sector.

Under the Fair Trading Act 1973 it is the Director General of Fair Trading who shall advise the Secretary of State on a merger situation⁶⁶. The Office of Fair Trading and OFFER came up with a 'home-made' solution to create a role for the Director General of OFFER in connection with electricity mergers. The two Directors General agreed in a Concordat that the Director General of Fair Trading shall seek the views of the Director General of OFFER "on bids involving electricity licensees."⁶⁷ Hence OFT consulted OFFER in connection with electricity mergers, although the former was under no statutory obligation to do so. One may argue that the two Directors General had at least two reasons to execute the Concordat:

- (i) The incumbent Director General of Fair Trading, Sir Bryan Carsberg, is the former head of OFTEL. Sir Bryan Carsberg is then well aware of the fact that OFFER had no power to interfere in electricity mergers. The Concordat tried to remedy this shortcoming of the Electricity Act 1989.
- (ii) OFFER knows the ins and outs of the electricity industry, while OFT is a general competition agency. It would have been unfortunate then if the former could have had no jurisdiction over electricity takeovers. The Concordat was a

⁶²Graham Stedman: Takeovers (1993), page 505., point 19.4.11.

⁶³Section 3(1)(a) of the Electricity Act 1989.

⁶⁴Maurice Button and Fiona Buxton: A Practitioner's Guide to the City Code on Takeovers and Mergers (1996), page 98., point 3.3.2.

⁶⁵See reference to draft licence amendments of 7 September 1995 In: OFFER - OFWAT: Takeover of Southern Water plc. by Scottish Power plc and Southern Electric plc. (31 May 1996).

⁶⁶Section 76 of the Fair Trading Act 1973.

⁶⁷OFFER: Annual Report (1995).

convenient solution to bring expertise and jurisdiction together; this co-operation benefited both offices.

It is important to keep in mind that two separate, although in the case of electricity mergers overlapping functions are here: (a) merger control and (b) utility regulation. As was mentioned above, under the Fair Trading Act 1973 the Secretary of State is the ultimate decision-maker as far as the fate of bids is concerned; the Director General of OFFER may exercise certain auxiliary rights under the Electricity Act 1989 in connection with takeovers. Should the distinction between points (a) and (b) become blurred, dubious conclusions may follow, like:

It should be stressed that the regulator (as issuer of licences) will have an effective veto over any mergers . . . ⁶⁸

Had the Director General of OFFER had the right to veto mergers, then not many RECs would have been taken over; Professor Littlechild was not the strongest supporter of the Big REC Race. He asked the Secretary of State to refer bids to the MMC; his recommendations were ignored on more than one occasion. But Professor Littlechild had no statutory power to block bids: his role under the mentioned Concordat was purely advisory.

To conclude, privatisation Acts did not give the Director General of OFFER *carte blanche* as far as merger control in the electricity sector is concerned. Strategic decisions about electricity takeovers are reserved for the Secretary of State in the UK.

(3) Privatisation legislation reconsidered

The Big REC Race highlighted two shortcomings of the Electricity Act 1989.

- No automatic reference to MMC

As was mentioned under point (2) above, ordinary merger control rules applied to the Big REC Race. Under the Fair Trading Act 1973 it is up to the Secretary of State (i) whether a bid is referred to MMC; and (ii) whether he accepts the MMC's recommendations or not. It was also mentioned that the Secretary of State exercised his discretionary powers in a way which fostered party (as opposed to competition) policy: the National Power/PowerGen bids were referred to the MMC on purely political grounds.

The Electricity Act 1989 did not give any guideline as to the use of this discretionary power. With hindsight, one may argue that the Act could have provided that mergers likely to create (a) horizontally integrated companies or (b) 'multi-utilities' must be referred to the MMC. The term 'multi-utilities' should be explained here. Multi-

⁶⁸Stephen Dow: A Survey of Major Developments in the Post-privatisation Phase of the UK Gas and Electricity Industries (1996), page 49.

utilities offer two or more utility services in the same geographical area. **United Utilities** (North West Water - Norweb) and **Hyder** (Welsh Water - Swalec) are examples.

There is an automatic reference clause in the water industry. Sections 32. and 33. of the Water Industry Act 1991 provide that the Secretary of State shall refer a merger between two water enterprises if the gross assets of each enterprise exceeds GBP30m.⁶⁹ It is hard to understand why the legislator failed to introduce an automatic reference clause in the case of the electricity, gas, and telecommunications sectors. With hindsight, an automatic reference - clause would have been quite useful in the electric industry: it could have reduced uncertainty as to which bids will be referred to MMC.

- No 'change of control' clause

It was argued above that the Director General of OFFER had no jurisdiction over merger references: he could seek modifications to licences, but had no power to block a proposed merger involving electricity licensees. Neither the Electricity Act 1989 nor the distribution licences contain a 'change of control' clause⁷⁰: thus the takeover of an electricity company is not conditional upon the approval of OFFER.

Utility regulators have more control over mergers and acquisitions in other European countries. For example, no person may acquire more than 25% of the shares in an electricity licensee in Hungary without the prior, written approval of the Energy Office.⁷¹

The 'change of control' clauses should be set forth in Acts of Parliament in Britain. Licence modifications making the transfer of stakes conditional upon OFFER's approval might not be good enough: this option would not give a direct right to the Director General to interfere under British company law. As will be explained in Chapter 6. below, a utility licence is seen as a contract between regulator and regulated in Britain. A predator intending to acquire control over a licensee is NOT a party to that 'contract': as a rule, licences bind licensees (i.e. utilities) but not their existing or would-be shareholders. Thus 'change of control' clauses should have been inserted into the privatisation legislation in Britain.

(4) Comparative takeover procedures

The Big REC Race is likely to remain a one-off experience in the European history of privatisation.⁷² At least two things would be necessary to repeat the Big REC Race in

⁶⁹OFWAT: The Changing Structure of the Water and Sewage Industry in England and Wales (1996).

⁷⁰National Power: Recommended Cash Offer for Southern Electric (1996), page 11., point 13.

⁷¹Section 24 of the Hungarian Electricity Act 1994.

⁷²A number of mergers took place in the Spanish electricity sector. However, these were intra-industry consolidation. Spanish energy and bank groups are reported to form 'hard nuclei' to deter

other countries: (i) privatised utilities and (ii) reasonable takeover regulation. Referring to the "Horses for courses" maxim one may argue that in some countries there are no horses, while others seem to have no courses.

(i) Horses: Corporate governance culture

As a rule, 'horses' (i.e. privatised utilities) are in short supply in Europe. First of all, few European countries have opted to sell energy distribution companies. While telecommunication companies have been privatised in most EU countries, the disposal of electricity distributors does not seem to be on the agenda. The main reasons for the relatively small number of disposals are (i) the conceived political and regulatory implications of electricity privatisation (see Introductory comments above); (ii) lack of regulatory arrangements⁷³; and (iii) unsuitable ownership structure.⁷⁴

Secondly, not many European countries adopted the British version of corporate governance: mechanisms for monitoring management in Germany and in the Central European countries are different from those in the UK. Comparative studies divide the national brands of corporate governance into two main groups: (i) the British - American **outsider** system and (ii) the German - Japanese **insider** system.⁷⁵ The contrast between the two systems is most striking in the fields of (a) liquidity and (b) supervision of managers.

- The Outsider System puts the emphasis on liquidity in the stockmarket: investors want to be sure that they will be able to sell their shares in the future. Shareholders do not meddle in company management; but if a company does not perform well in the stockmarket, shareholders would sell off their stakes straightaway. Plummeting share prices may spawn a hostile takeover. Thus stock exchange indexes are the most important means of monitoring managers. Inter-corporate equity holdings are few and far between.
- The Insider System prefers close monitoring to liquidity. Heavyweight shareholders are the key players here: they hold substantial stakes and are keen to monitor managers closely. More often than not supervisory boards and boards of

takeover bids. Source: Eugene D. Cross: *Utility Regulation in the European Union* (1996), page 209. and *Power in Europe*, May 3, 1996, page 22.

⁷³ Austria, Belgium, France, Greece, Ireland, Italy, the Netherlands, and Portugal have no adequate regulatory system. Source: Centre for the Study of Regulated Industries: *Regulation International* 1997 (1997), pages 4 - 5.

⁷⁴For example, municipalities and consumer co-operatives own distribution companies in Germany and in Denmark. Source: Eugene D. Cross: *Utility Regulation in the European Union* (1996), page 323. and 324.

⁷⁵A Survey of Corporate Governance In: *The Economist*, January 29 1994; G. P. Stapledon: *Institutional Shareholders and Corporate Governance* (1996), page 3.; and J. E. Parkinson: *Corporate Power and Responsibility* (1993), pages 170 - 171.

directors are packed with delegates from major shareholders; employees are also represented on the supervisory board. Inter-corporate holding is widespread. Shareholders do not sell their stakes if a company runs into trouble, but rather reshuffle the board and tighten management monitoring rules.

This simplified description would suffice to conclude that takeovers suit more the Outsider than the Insider System. While both of these systems exist in Europe, there is little doubt that 'Insider' countries dominate the EU market for the time being. As the Commission of the European Communities notes, "takeover activity is concentrated in few member states and that opportunities in different member states remain uneven."⁷⁶

The point here is that shareholders and managers forge close links that bind in 'Insider' countries: a shareholder who controls a big chunk of shares and has the right to appoint board members will think twice before selling her/his stake. And even then existing shareholders tend to sell to a fellow shareholder, rather than to a third party. Shareholders of private limited companies have a statutory pre-emption right to acquire shares from a vendor; while the biggest shareholders in public limited companies tend to stipulate similar pre-emption rights in shareholders' agreements.

J.E. Parkinson points out an additional barrier to takeovers. A simple majority is not sufficient to obtain management control in the Insider System; an extraordinary resolution is often necessary to oust directors. Furthermore, a shareholder may not remove employee representatives from the supervisory board.⁷⁷

Hence a takeover bid from an outsider is a rare curiosity in the Insider System. As the chairman of Deutsche Bank commented, the collapse of the Krupp - Thyssen merger showed that "we lack a takeover culture and a full understanding of corporate governance in Germany".⁷⁸

An Austrian practitioner makes a similar point; Stefan Köch argues that takeover is peculiar in Austria

in that virtually no public takeover offers have been made, and in particular no hostile public takeover offers. In other words practically all takeovers result from privately negotiated deals between a very limited number of shareholders.⁷⁹

To sum up, takeovers are more the exception than the rule in Insider Group countries. German, Italian, Austrian, or Central European companies are not proper targets for potential predators: (i) a few heavyweight shareholders control big chunks of shares;

⁷⁶Maurice Button and Sarah Bolton (editors): *A Practitioner's Guide to Takeover Regulation and Practice in the European Union* (1997), page 17., point 4.2.

⁷⁷J. E. Parkinson: *Corporate Power and Responsibility* (1993), page 148.

⁷⁸The Financial Times, 14 June 1997.

⁷⁹Stefan Köch: Austria. In: Maurice Button and Sarah Bolton (eds): *A Practitioner's Guide to Takeovers and Mergers in the European Union* (1997), page 51.

(ii) stockmarkets offer limited liquidity; (iii) existing shareholders may not sell to an outsider; and (iv) a simple majority is not sufficient to obtain management control. Thus the above mentioned countries have no 'horses' for a Big REC Race-style takeover frenzy.

(ii) Courses: Takeover procedures

If merger regulation is the 'course' for takeover 'races', then the City of London was a second to none course for the Big REC Race. Ever since the publication of the first City Code on 27 March 1968⁸⁰ a self-regulatory body, the Panel on Takeovers and Mergers [hereinafter: the Panel], had been in charge of supervising merger activities in the UK. The distinguishing feature of self-regulation is that practitioners lay down certain rules for themselves and agree to comply with those rules without external interference.⁸¹ Whether self-regulation is superior to state regulation is a matter of political belief, but one point is beyond doubt: self-regulation tends to be more user-friendly than state imposed rules. The Panel administers the City Code on Takeovers and Mergers [hereinafter: the Code] with a view to satisfy the practical needs of predators and target companies. Thus self-regulation is likely to develop towards down-to-earth rules, while Acts of Parliament may provide for more complicated procedures. The comparative analysis of British and Hungarian merger rules will prove that the former is the better 'course' for takeover 'races'. It will be argued below that Hungarian legislation is in such a muddle that there is no 'course' for post-privatisation takeover 'races'.

Merger control is the domain of legislation in Hungary: it is Section 323. of the Companies Act 1988 which sets forth takeover rules. The short summary of the relevant Hungarian provisions would be as follows:

- Majority interest

XYZ plc. has a majority interest in ABC plc. if XYZ (a) has acquired more than 50% of the issued share capital of ABC, OR (b) controls more than 50% of the votes at any general meeting of ABC.

- Notice to shareholders

If XYZ plc. intends to acquire a majority interest in ABC plc., then the offeror must give a notice to ABC shareholders. The notice must state (i) the number and class of shares to be purchased, (ii) the purchase price per share, and (iii) a time limit for an option (see next point).

⁸⁰The history of the first City Code is discussed in detail in: Sir Alexander Johnston: *The City Take-over Code* (1980), Chapter IV.

⁸¹Sir Alexander Johnston: *The City Take-over Code* (1980), page 5.

- Option to buy

ABC shareholders have an option to purchase the above 50% portion of the block of shares XYZ plc intends to acquire. This option is subject to the same terms and conditions as stated in the above mentioned notice.

An example may help to understand the rules summarised above:

If XYZ plc. intends to acquire a 65% stake in ABC plc., it must send a notice to existing ABC shareholders; after the notification ABC shareholders have an option to purchase 15% (65% - 50%) of the shares to be acquired by XYZ plc.; should ABC shareholders not exercise that option, then XYZ plc. may acquire the 65% stake in ABC plc.

It is to be admitted that Hungarian merger control rules do not seem to make much sense. Compared with the British Mandatory Rule (Rule 9. of the Code) five potential flaws may be pinpointed:

(1) Option *versus* bid

(a) UK provision

Rule 9. of the British Code provides that, if certain conditions are fulfilled (see below), a person must make an offer to acquire all equity shares in the target company. This is the Mandatory Offer. Similar provisions apply in France⁸² and the draft Thirteenth Company Law Directive also includes a slightly modified version of the Mandatory Offer rule.⁸³

(b) Hungarian provision

Existing shareholders of the target company have an option to purchase shares.

(c) Comparative points

Hungarian merger regulation does not seem to harmonise with UK or EU rules: European legislation tells the predator to purchase shares, while the Hungarian Act asks the predator to hang on until after the option expires (usually 30 days).

⁸²J. Le Gall: French Company Law (1992), page 127.

⁸³Article 4(1) of the draft 13th Company Law Directive. OJ C 64, 14.4.1989. For a detailed analysis, see: Maurice Button and Sarah Bolton (editors): A Practitioner's Guide to Takeover Regulation and Practice in the European Union (1997), pages 15 - 17., point 4.2.

(2) Onus of payment

(a) UK provision

It follows from point (1) that Rule 9. puts the onus of payment on the predator in the UK.

(b) Hungarian provision

Existing shareholders must put up money if they intend to exercise the option mentioned.

(c) Comparative points

The Hungarian arrangement is rather unfortunate. Predators plan the acquisition of a target company in advance and launch the bid once financing has been arranged; it is quite likely that they will have the financial muscle to complete the transaction. On the other hand, an option to buy shares is a bolt from the blue for existing shareholders in Hungary: the option may lapse before they could find the money to finance the acquisition of shares.

(3) Trigger limits

(a) UK provision

Rule 9. provides that a Mandatory Offer shall be made if a person acquires shares which carry 30% or more of the voting rights.

(b) Hungarian provision

There are two trigger limits in Hungary: (i) 50% of the issued share capital OR (ii) 50% of the votes at general meetings.

(c) Comparative points

The rationale for different trigger limits (30% or 50%) is that the UK belongs to the Outsider System, while Hungary is a member of the Insider System. Large number of shareholders own relative not too big chunks of shares in Britain. On the other hand, shareholdings are not scattered in Hungary; few heavyweight shareholders control

companies. Hence a 30%⁸⁴ holding is considered to represent effective control in the UK, while the Hungarian legislator worked on the assumption that a less than 50% holding is not sufficient to control a company. The trigger limit is also 50% in the Czech Republic;⁸⁵ while Slovenia set the limit at 25%.⁸⁶ As a rule, different corporate governance cultures call for different trigger limits. Hence it would be inappropriate to replace 50% with 30% in the Hungarian legislation, or *vice versa*.

What is hard to accept is that there are two trigger limits in Hungary: (i) 50 % of the issued share capital and (ii) 50% of the votes at general meetings. The following example will show that the co-existence of the two limits mentioned may lead to a logical impossibility:

A Hungarian public limited company issues two classes of shares: (i) 70 % of the shares (Class A) would be allocated to you; and (ii) I would get the rest of the share capital (Class B). Under the Articles of Association each Class B share would carry three votes at general meetings, while Class A shares would have one vote each. Thus if 1,000 shares were to be issued, then you would have 700 shares (70%) and 700 votes, while I would have 300 shares (30%) and 900 (300 x 3 = 900) votes.

Under the Hungarian merger control rules, this company would have two majority owners at the same time:

(i) You would hold a majority interest because you own 70 % of the issued share capital (700 shares).

AND

(ii) I would also be declared to have a majority interest: I control more than 50% of the votes (900 votes).

To avoid absurdity of this kind, one of the trigger limits should go. The best solution would be if the '50% of shares' rule were abolished. So far as merger control is concerned, it is irrelevant how many shares a shareholder owns; the question is how many votes that shareholder actually controls.

(4) Offerors subject to merger control

(a) UK provision

Rule 9. is intentionally vague as far as the offeror is concerned: it refers to a 'person' which may be an individual as well as a company.

⁸⁴Practitioners recommended that the 30% figure should be reduced in the UK; but the Panel refused this opinion in 1991. See: Maurice Button and Fiona Buxton: A Practitioner's Guide to the City Code on Takeovers and Mergers (1996), page 79., point 2.

⁸⁵Czech Republic section of East European Monitor, June 1996.

⁸⁶The Financial Times, 7 July 1997.

(b) Hungarian provision

Hungarian legislation is fairly specific: merger rules apply to 'public limited companies' only. It would appear then that merger control does not apply to other business entities recognised under the Hungarian Companies Act 1988, like partnerships, private limited companies and the like. In addition, a group of influential company lawyers further restricted the scope of companies subject to the Act. They suggested in a textbook published in 1993 that takeover rules may not be enforced against non-Hungarian companies: the Companies Act 1988 is only applicable to companies registered in Hungary.⁸⁷ The Hungarian privatisation agency accepted this interpretation without reservation.⁸⁸ While this interpretation may be correct theoretically, the outcome is certainly absurd: no reasonable Parliament would have intended to pass an Act which would encourage foreign predators to take over local companies. To conclude, rules on offerors subject to merger control should be amended in Hungary.

(5) Exemptions

(a) UK provision

The Code acknowledges that in certain circumstances it would be inadequate to require the offeror to make a mandatory bid. The latest edition of the Practitioner's Guide lists the following circumstances: (i) in case of new securities a 'Whitewash' dispensation may be available; (ii) foreclosure on security for loan; (iii) rescue operation from insolvency; (iv) innocent mistake; (v) non acceptance notice from 50% of shareholders; (vi) enfranchisement of non-voting shares; and (vii) redemption or purchase by a company of its own shares.⁸⁹

The proposed EU rules also acknowledge the need for exempting certain transactions from general merger rules.⁹⁰

(b) Hungarian provision

The Companies Act 1988 does not provide for dispensation. Hence, in theory, merger rules are to be enforced under any circumstances. Bearing in mind that the above listed circumstances may also arise in Hungary, it may be a good idea to introduce some exceptions.

⁸⁷dr. Csécsy Róbert - dr. Gadó Gábor - dr. Makai Katalin - dr. T. Nagy Erzsébet: Társasági jog és cégjog a gyakorlatban (1993).

⁸⁸East European Energy Report, March 1996, page 8.

⁸⁹Maurice Button and Fiona Buxton: A Practitioner's Guide to the City Code on Takeovers and Mergers (1996), pages 84 - 87., point 2.3.

⁹⁰Maurice Button and Sarah Bolton (eds): A Practitioner's Guide to Takeover Regulation and Practice in the European Union (1997), page 16, point 4.2.

The above discussion may be concluded then as follows: Hungary privatised six electricity distribution companies and five regional gas distribution companies in 1995: thus potential 'horses' exist in Hungary. But, and this is the main point, there are no 'courses' for takeover 'races'. Hungarian merger control is so unreasonable that no reasonable predator is likely to launch a bid. Hence it is unlikely that anything similar to the Big REC Race will take place in that country.

Conclusion

Speaking metaphorically, the electric industry in England and Wales was a new edifice built upon the ruins of CEGB. Compared with the old building, the designers introduced some structural changes: most important of all, the idea of vertical integration was refused. Golden Shares and limitation on shareholding clauses were introduced to 'prop up' this new structure. The main point of this Chapter is that as soon as the Golden Shares expired the new edifice collapsed: perhaps it was badly designed.

The above discussion has tried to argue the following points:

- Post-privatisation reorganisation is not necessarily a bad thing. Privatisation must not ossify company structures: privatised utilities should be able to adopt to changing market conditions. But where are the limits to these changes? The story of the Big REC Race seems to suggest that there might be NO pre-determined limits at all. It was argued above that the UK government inadvertently designed the future shape of the British electricity sector: it was not clear what will happen after the expiry of the Golden Shares. The government had no blueprint for the structure of the English and Welsh electricity sector beyond year 1995. Hence the English and Welsh electricity sector was a 'research laboratory' between July 1995 and December 1996. Investors tested (i) whether the idea of vertical integration might be acceptable; and (ii) how many takeovers politicians and regulators would tolerate.
- The government reacted spontaneously during the Big REC Race: the Scottish Power bid was cleared, while the National Power/PowerGen bids were blocked. The rationale for this policy may be that vertical integration is not welcome in England and Wales for the time being. Yet the Scottish system is vertically integrated; and the Big REC Race would have introduced vertical integration in England and Welsh. Why did the Secretary of State refuse to adopt the Scottish model in England and Wales? Perhaps the government still believes that the original industry model was right; yet the facts that (i) ten out of twelve RECs were taken over by December 1996 and (ii) two multi-utilities emerged show that investors do not necessarily agree on that point. The final remark here is then that the English and Welsh electricity sector will be further reorganised: vertical integration and intra-industry mergers are the likely directions of development.

- The Big REC Race may be a one-off episode in the history of European privatisation. The 'Outsider' corporate governance culture has no particularly strong tradition in Europe: with the exception of the UK and Ireland, all European countries belong to the 'Insider' group. Takeovers are few and far between in 'Insider' countries; compared with Britain, the legal regulation of mergers and acquisitions is less 'customer-friendly' in Europe. Hence mainland Europe may not host many REC-style races.

Chapter 6.

Privatisation in ex-CMEA Countries: The Story of the Hungarian Gas Distribution Sector

The previous five chapters have been concerned with British projects; it is high time to discuss some non-UK disposals. Privatisation, like the habit of having tea with milk, spread from Britain to Central and Eastern Europe: the sale of state-owned companies is the craze from the Czech Republic to Albania at present. This chapter does not intend to discuss general privatisation policy in Central and Eastern Europe; its scope is limited to energy, especially gas, privatisation. Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia pursued similar energy policies during the lifetime of Council for the Mutual Economic Assistance [hereinafter: CMEA]. Gas industries in the six countries listed above shared at least five common characteristics in 1991 when CMEA was dissolved. The simplified description of these points would be as follows:

1./ **Import**

Gas production was insufficient to meet domestic requirements in all the six countries listed above; each country was heavily reliant on import. Russia was the sole supplier of natural gas to ex-CMEA countries.

2./ **Tariffs**

Energy prices were distorted: charges had little to do with costs. As a rule, there were three categories of customers: (i) domestic; (ii) general purpose (e.g. schools, sport centres etc.); and (iii) industrial. Each category of consumers paid a nation-wide flat tariff. Tariffs (i) and (ii) were cross subsidised; compared with domestic customers, industrial users paid more for gas, although the latter was the cheaper to supply.

3./ **Network Financing**

Ex-CMEA governments did not have sufficient funds to finance the expansion of the gas distribution networks: capital expenditure programmes were frequently ignored. Underinvestment characterised gas industries in the region.

4./ **Companies**

Energy industries were centralised; one national electricity, gas, telecommunication etc. enterprise operated in each country. The legal status of these utilities varied from country to country. As a rule, none of them was a Companies Act-like company. Ministry officials (as opposed to managers) made strategic decisions; and some utilities were

organised as ministerial departments (just like telecommunications in the UK before the passage of the Post Office Act 1969); while others were a kind of half-way house between departments and companies.

5./ **Law and Regulation**

Legislation was badly out-of-date. Acts were more a collection of political declarations than a set of norms. No western-style economic regulation was in place: regulatory and ownership functions were not separated.

The above mentioned five issues did not create an ideal environment for market reforms: every ex-CMEA country was to have a bumpy road to privatisation. It was Hungary which pioneered large-scale energy privatisation in Central Europe; six electricity and five gas distribution companies were sold off in 1995. These disposals are unprecedented: no other government in the region has sold, or is likely to offer for sale, (i) majority stakes (ii) in energy distributors (iii) to foreign investors. This Chapter will discuss how Hungary coped with the above mentioned five issues.

Compared with the previous Chapters, this piece will have less footnotes and references; there are two reasons for this: (i) Hungarian energy privatisation was not discussed in the international press in detail. (ii) This Chapter draws on private experience gained while working on the sale of the Hungarian gas sector. To the best of my knowledge, some points discussed below have not been published before. A number of references will be made to the Hungarian gas legislation; the English translation of the relevant sections from the Gas Act 1994 may be found in Annex 1.; while Annex 2. is a short glossary of frequently used terms.

The structure of this chapter will be as follows: Part I. will discuss how Hungary dealt with the five problem areas identified above between 1991 and 1994. Part II. will highlight further developments in the year of privatisation (1995); and finally Part III. will consider what changes happened in the post-privatisation phase in the Hungarian gas sector. The Conclusion will summarise what lessons other Central and Eastern European countries might learn from Hungary.

Part I.

Years of Preparation (1991 - 1994)

Hungary started a radical privatisation programme in 1990 after the election of a new government. The partial privatisation of the gas distribution sector was first considered in 1991; but no tender for sale was issued. Problems arising from the common heritage of the CMEA energy policy (see points 1 - 5 above) were to be resolved first. The following developments happened in Hungary between 1991 and 1994:

1.1. Import

Mixed record on Russian influence

In the short term Hungary could import gas from the former USSR: the only international transmission pipeline connected Hungary *via* Ukraine to the Russian gas fields of Orenburg and Yamburg. But there was a growing anti-Russian feeling in the country; the new right-wing government was alarmed that Russians wanted to take over Hungarian gas companies. The dilemma was how to secure future gas supply from CIS without allowing the Russians to dominate the domestic energy sector. The government pursued a double-edged policy after 1990:

- On the one hand, the new government was determined to diversify gas supply. MOL, the national oil and gas concern, signed a gas supply agreement with Ruhrgas, a German utility, in January 1991.¹ This agreement was nothing more than a gesture: there was no pipeline between Germany and Hungary. (see 3.1. below)
Austria and Hungary agreed to construct a high-pressure pipeline with a maximum capacity of 4 - 4.5 bncm per annum (the HAG pipeline): this pipeline was to connect Hungary to the West European transmission system. The 118 km length of pipeline was scheduled to be operational by 1996.
- On the other hand, the volume of Russian gas supply continued to rise: after 1990 domestic production could satisfy less than 50% of total demand. In the early 1990s Hungary was more reliant on Russian gas than at any other time before.² Total domestic consumption was around 10bncm per annum in the early 1990s, out of which 6.3bncm was imported from Russia. Around half of the imported gas was supplied pursuant to inter-government agreements (Orenburgh and Yamburg agreements); while MOL and Gazprom contracted for another 3bncm per annum.³ A MOL - Gazprom (Russian gas giant) joint-venture (Panrusgaz) was set up in 1994 to facilitate the import of Russian gas.⁴

Thus Hungary did not need to worry about gas import in the early 1990s: (i) it was a decided question that Hungary would be connected to the West European gas network; and (ii) Hungary also succeeded in securing Russian imports: the newly established Panrusgaz was seen as a guarantee that there would be no shortage of imported natural gas.

¹East European Energy Review [hereinafter: EEER], February 1991, page 22.

²Economist Intelligent Unit [hereinafter: EIU]: Country Profile: Hungary (1995 - 96), page 21.

³EEER, March 1994, page 28.

⁴EEER, October 1994, page 23.

1.2. Tariffs

No price increase

The new government's energy price policy was a policy of extremes. On the one hand, the petrol and diesel retail business was liberalised in 1990; fuel prices rocketed to international level. On the other hand, there were no gas or electricity price hikes after 1992. Although the annual rate of inflation was 25.4% per annum between 1991 - 1995⁵, the government refused to increase gas tariffs. As a result, consumer tariffs were below the import price⁶: tariffs were not linked to import, transport, and construction costs. MOL lost \$300m in 1994, and \$210m in 1993 on gas import.⁷ Household tariffs remained cross subsidised: what domestic customers paid for gas was a symbolic contribution to expenses, rather than a real tariff.

1.3. Network Financing

Municipalities as investors

Artificially low gas prices spawned a dash for gas in Hungary. The number of potential customers requesting gas supply boomed. Annual gas consumption multiplied as follows:⁸

year	1980	1985	1987	1990	1991	1992	1993
consumption	100	178.1	260.1	318.2	387.0	400.2	464.0

TABLE 19: Annual gas consumption in Hungary between 1980 and 1993

But gas companies had limited financial resources to expand the distribution network: as was mentioned above, energy prices were frozen, while inflation was soaring. The state did not provide sufficient funds either. Thus municipalities took the lead.

The Gas Act 1969 did not provide that only gas enterprises may construct pipelines. Hence municipalities and special 'constructing communities' built pipelines from local resources. The financing of pipelines was organised as follows:

Step 1. - The competent local municipality ordered a feasibility study from the regional gas enterprise to estimate the total costs of connection.

Step 2. - The municipality portioned out costs among would-be customers; every household was requested to pay its share to a fund.

Step 3. - Having collected the money the municipality ordered the construction of pipelines from the local gas enterprise.

⁵EIU: Country Forecast: Hungary (fourth quarter, 1996), page 2.

⁶Peter Cameron: Gas Regulation in Europe (1995), Volume 2., page 89.

⁷EEER, September 1994, page 17.

⁸Source: Népszabadság, 14 September 1994.

This financing regime defied common sense: it was not the gas enterprise but would-be customers who paid for the construction of new pipelines. The cost of construction was collected from customers in cash; this sum was paid over to the gas enterprise before the construction of pipelines would have commenced. Yet it is easy to understand why this method of financing was popular: tariffs were not cost reflective, construction costs were not built into gas prices. Hence gas enterprises could not finance the construction of pipelines from turnover. If new customers wanted gas they had to pay for pipelines. Absurd as this idea might appear, this system of 'project financing' worked well in practice:⁹

Year	1985	1990	1993
Length of pipelines (km)	9,333	17,399	30,587

TABLE 20.: Total length of pipelines in Hungary

Paradoxically, it was municipality financing which kept gas tariffs at an artificially low level in Hungary: the cost of pipeline construction was NOT a built-in element of prices, hence gas was cheap. It will be argued below that this bargain (*low gas prices but do-it-yourself construction*) will be the 'old ghost' of the Hungarian gas privatisation; it may be blamed for delaying the sale of the gas industry.

While principles of network financing were not reformed (would-be customers financed the construction of distribution pipelines) until 1994 (see point 1.5 above), two points should be noted here:

(i) Third party owned pipelines

As a rule, pipelines financed by (i) the local municipality and/or (ii) would-be customers were transferred to the gas distributors free-of-charge until November 1992. Section 19 of the Gas Act 1969 provided that

The gas distribution enterprise may make the concluding of the contract [i.e. the contract to give a supply of gas] conditional upon the requirement that the consumer shall have that part of the connecting pipeline which is situated on public territory constructed partly or fully on his own expense, and then shall give such pipeline into state ownership (in the management of the gas distribution enterprise) free of charge.

After the coming into force of a new Constitution in 1989 municipalities claimed that the provision quoted above was unconstitutional: gas enterprises must pay for pipelines constructed from local resources. The government yielded to municipality pressure in 1992: Decree (23/1992. (XI.17.) IKM) repealed the

⁹GiroCredit Research: The Gas Sector in Hungary (December 1994), page 30.

obligation to hand over pipelines free-of-charge. Hence gas enterprises did not acquire the ownership of new pipelines automatically after November 1992: suppliers and municipalities negotiated on what terms and conditions municipalities would sell newly-constructed pipelines to the local gas distributor. If the two parties could not agree, which was not unusual, municipalities (i) retained the ownership of pipelines but (ii) granted a 'quasi-franchise' to the local gas enterprise to operate those pipelines. The latter was not in a position to refuse this 'offer': as will be discussed under point 1.5, gas enterprises were obliged to supply customers. Hence gas companies supplied gas through third-party owned networks after 1992.

(ii) Compensation

An Act of Parliament was passed in 1993 (Act LXXXII of 1993) to compensate municipalities for making financial contribution to the construction of pipelines in the past. Municipalities were to receive gas company shares free-of-charge. This issue will be examined further under point 2.3 below. The point here is that municipalities re-appeared as owners in the Hungarian gas sector after a forty year-break.¹⁰

1.4. Companies

Re-organisation

The old giant enterprise, OKGT, was wound up in 1991¹¹; MOL and five regional enterprises were established. The five state-owned enterprises were re-registered as Company Act-like companies between January and July 1993. The transformation of gas *enterprises* into *companies* was a book-keeping exercise. Nonetheless one point should be noted here: unlike its British counterpart, the Hungarian government did not write off debts at transformation. The newly registered gas companies were *general* legal successors to the enterprises: liabilities followed assets and, as a rule, no debts were written off. As was discussed in Chapter 4., a somewhat different procedure was followed in Britain: the story of the nuclear energy sector is an example.

Two organisations were in charge of the management of the newly registered regional gas distribution companies [hereinafter: GDCs]:

- (i) The State Property Agency exercised ownership rights over the GDCs after the coming into force of Act VII of 1990 on privatisation.
- (ii) Decisions on energy policy, technical supervision, and price regulation remained the responsibility of the Ministry of Industry and Trade.

¹⁰Like in the UK, the first gas works were municipality owned in Hungary. Gas enterprises were nationalised in the late 1940s.

¹¹EEER, October 1991, page 2.

In 1992 a new privatisation agency, the State Holding Company [hereinafter: SHC], was established to manage, among others, energy companies; thus the GDCs were transferred to this agency. But the newly established privatisation agency had no effective control over the five gas companies; a new symbiosis emerged between the SHC and local managers. The privatisation body had neither expertise nor information to run the GDCs; the SHC was reliant upon GDC management. As a rule, local managers co-operated with the privatisation agency if and when it was in their best interest to do so. If the SHC and GDC managers fell out, the Ministry of Industry and Trade backed the latter. Two examples may be mentioned here:

(i) Botched reshuffling

The SHC intended to remove four (out of five) General Managers in the run-up to privatisation. The Ministry was against reshuffling. Although 'a string of management changes' was reported in the press¹², in fact no General Manager was recalled. The Ministry and the SHC agreed that a new Deputy General Manager [hereinafter: DGM] should be delegated to each GDC. The primary duty of the DGMs was to supervise the day-to-day operation of the gas companies. But this arrangement did not quite work in practice. The General Manager of two GDCs refused to co-operate with the newly appointed DGMs. SHC did not interfere: the General Managers had the full support of the Ministry of Industry and Trade. Hence incumbent General Managers remained in power throughout the privatisation process.

(ii) In-house hostile takeover

SHC decided to merge an oil-gas export company (Mineralimpex) into MOL in 1994. Both companies were majority state-owned; the merger was deemed to be completed in May 1995 when the SHC transferred around 90% of the Mineralimpex shares to MOL. Yet the Ministry of Industry and Trade was not happy with the merger and tried to rescue Mineralimpex from what was described as an in-house hostile takeover. Hence an internal battle between MOL and its 90% owned subsidiary erupted; the 'in-house hostile takeover' went on until Spring 1996.¹³

To conclude, it was not absolutely clear 'who was controlling whom' in the Hungarian gas industry. The examples mentioned above show that the state is not a particularly good owner: private investors would presumably make sure that their appointees are actually appointed and shares are re-transferred between two wholly owned subsidiaries as soon as possible.

¹²EEER, September 1995, page 15.

¹³EEER, April 1996, page 22.

1.5. Law and Regulation

New Acts of Parliament

Two models existed for the regulation of energy industries in the ex-CMEA group. Poland, Czechoslovakia, and Romania had 'umbrella' Energy Acts: these pieces of legislation set forth common rules applicable to oil, gas, electricity, and the district heating industries. The structure of energy legislation had never been the same in Hungary: traditionally a number of Acts regulated the Hungarian energy sector, and no 'general' Energy Act as such was passed. The following pieces of legislation were in force in 1991:

- Mining Act (Act III of 1960);
- Electricity Act (Act IV of 1962); and
- Gas Act (Act VII of 1969).

A number of Government and Ministerial decrees contained auxiliary (mainly operational and safety) rules.

In addition to Acts and Decrees, the Hungarian Civil Code also set forth provisions relevant to energy distribution. Sections 387 - 388. of the Code provided that energy suppliers were to supply consumers safely and continuously. Furthermore, energy Acts frequently referred to the general provision of the Civil Code in connection with third party rights, compensation for damages, breach of contract etc.

The government announced its intention to replace old energy Acts with a new generation of statutes in 1992. Three new Acts came into force between 1993 and 1994: the Mining Act 1993, the Gas Act 1994, and the Electricity Act 1994. The main points of the Mining and Gas Acts may be summarised as follows:

Mining Act (Act XLVIII of 1993)¹⁴

The new Mining Act was intended to restrict state ownership and state involvement in the mining of mineral resources, hard minerals, and the exploitation of hydro-carbons. After the abolition of state monopoly rights, any Hungarian or foreign company might apply for a mining concession. The Mining Act empowered the Minister of Industry and Trade to grant concessions. As far as hydro-carbons were concerned, the new Act declared that the transmission of oil and gas through pipelines was an exclusive state activity; anybody intending to construct or to operate transmission pipelines would have to apply for a concession. In fact, no such concession was granted and MOL retained a *de facto* monopoly in the transmission business.

But this monopoly was not without obligations: drawing on British experience¹⁵, the new Act introduced the first Third Party Access rules in mainland Europe.

A leading gas specialist defined Third Party Access as follows:

¹⁴EEER, May 1993, page 21.

¹⁵Section 19. of the Gas Act 1986.

... a commercial transaction under which owners of transportation assets either agree, or are obliged, to carry gas - which they do not own - for a third party.¹⁶

Hungary introduced the 'obliged to carry' model: MOL was ordered to allow access to its oil and gas transmission pipelines subject to certain conditions.¹⁷

So far as Third Party Access is concerned, Hungary was well ahead of other countries in the former COMECON block. For example, the biggest oil and gas producer in the region, the Russian Federation, did not legislate on Third Party Access. The 'Journal of the Newly Independent States of the Former Soviet Union Law Committee' reports that in late 1997 there was no

... foundation act [i.e. Act of Parliament] with the power of law to support the entire system of legal regulations for oil transportation through pipelines.¹⁸

The lack of statutes was only one of the problems in Russia. Compared to Third Party Access, the procedure to obtain access to transmission pipelines was rather complex. It is to be recalled that in Hungary oil and gas producers had access to MOL's transmission system subject to certain exceptions as defined in the relevant Government Decree. In Russia, the right of access was regulated as follows:

- Producers should submit an application for oil transmission to TRANSNEFT (i.e. a company established in August 1993 to transport oil in Russia);
- TRANSNEFT should forward (i) the said application and (ii) information on the capacity of pipelines to MINTOPENEGO (i.e. Ministry of Fuel and Energy of the Russian Federation);
- MINTOPENEGO should (i) prepare suggestions for the usage of trunk pipelines and (ii) submit such suggestions to an Interdepartmental Commission for review;
- Finally, MINTOPENEGO 'in coordination with' the Interdepartmental Commission approves or rejects applications.¹⁹

If potential investors were asked to choose, it is quite likely that they would opt for Third Party Access as introduced in Hungary: the Russian procedure may need some amendments to satisfy basic requirements of the 'Rule of Law'.

¹⁶Jonathan P. Stern: Third Party Access in European Gas Industries (1992), page 21.

¹⁷Section 24(2) of Act XLVIII. of 1993, and Section 10. of Government Decree 115/1993 (VIII.12.) Korm.

¹⁸Jay T. Kolb, Glenn S. Kolleeny, Dmitry Penstov: Legal Aspects of Transportation of Oil and Petroleum Products from Russia In: Journal of the Newly Independent States of the Former Soviet Union Law Committee, Summer/Fall 1997, pages 80 - 96, at 86.

¹⁹For a detailed description of the Russian procedure, see: Joy T. Kolb, et. al., *ibid.*, pages 90 - 91.

But Third Party Access had a short life-span in Hungary. It was feared that Russian gas companies might take advantage of the Third Party Access obligation and would sell directly to GDCs.²⁰ It is interesting to note that the Polish national oil and gas concern (PGNiG) used exactly the same argument when the government intended to introduce Third Party Access in Poland.²¹

In response to a scandal involving the illegal trade of oil to Slovakia *via* MOL pipelines the Government Decree on Third Party Access was repealed in 1995. Thus gas transmission was *de iure* liberalised under the Mining Act 1993; yet it remained a *de facto* monopoly.

Gas Act (Act XLI of 1994)

The Gas Bill intended to revolutionize energy regulation in Hungary: first of all, the Bill called for the establishment of an independent energy regulator. The intention was to set up a regulatory office which would be in charge of both gas and electricity sectors; the British model of single-industry regulatory offices was not followed. Secondly, the Gas Bill introduced a new, western-style licensing regime.²² In addition to regulation and licensing, four additional issues should be highlighted here:

- Legal status of regulatory office

It was mentioned in Chapter 2. that single-industry regulatory offices are non-ministerial government departments in the UK. Thus regulators are not ordinary administrators: (i) they have a special, quasi-judicial **status**²³; (ii) they maintain a special **relationship** with the regulated companies which involves much negotiating and bargaining; and (iii) they set **procedures** for themselves.²⁴ The Hungarian legislator did not transplant the British rules on this point. The Energy Office (i) has no judicial status; (ii) is supposed to act as an ordinary administrator; and (iii) is subject to the Code on Administrative Procedure.

Hence the Hungarian Energy Office has a less fortunate legal status than its British counterpart. Administrative law in Hungary does not recognise that utility regulators are, or should be, more co-operative than ordinary administrators. The Gas Act 1994 or the Code on Administrative Procedure do not provide that kind of flexibility which is the *sine qua non* of utility regulation in Britain.

²⁰EEER, February 1995, page 19.

²¹EEER, May 1995, page 5.

²²For details, see point 2.5 below.

²³C.D. Foster: Privatization, Public Ownership and the Regulation of Natural Monopoly (1992), page 276. and Section 27F(6) of the Telecommunications Act 1984, as amended.

²⁴C.D. Foster: op. cit., page 275.

- Territorial exclusivity

The Gas Bill sought to grant exclusivity in favour of gas companies: no competing suppliers might be appointed to serve an area licensed to an existing licensee. To appreciate this point it should be noted that the Gas Act 1969 did not recognise territorial exclusivity; in theory, would-be customers were free to choose their gas suppliers.²⁵ A report from an expert panel (Csete-committee) concluded in 1993 that two gas enterprises *were* serving customers situated in the historical areas of other gas enterprises. Thus territorial exclusivity did not exist in Hungary; gas distributors had no exclusive rights under the 'old' legislation (Gas Act 1969). To conclude, 'cross-boundary' supply was legally possible in the 'old days': territorial exclusivity was introduced in the run-up to privatisation.

- Price regulation

Part VII on Prices was the shortest (some 60 words) and weakest point of the Bill. Price regulation was to remain the responsibility of the Ministry of Industry and Trade. According to the Bill, the Energy Office was required to prepare proposals, but it was for the Minister to fix tariffs. The proposed new price regulation was a compromise between (i) what the SHC and investors wanted (i.e. cost-reflective gas tariffs) and (ii) the political unwillingness to liberalise gas tariffs. As will be seen below this compromise remained one of the most controversial issues in the history of Hungarian energy privatisation.

- Network financing

The Bill was a break-through in the field of network financing; it introduced the idea of Connection Charge.²⁶ The main rule is that potential new customers are obliged to contribute towards the costs of network development not covered by the official price of gas. Compared with the 'old' system as described under 1.3, would-be customers are better off under the new regime. As was mentioned above, customers had to construct connecting pipelines at their own expense in the past; under the new regime would-be customers are required to pay for that portion of construction costs which is not covered by prevailing gas tariffs.

- Duty to supply

Licensed distributors were obliged to supply customers on request under the 'old' Gas Act, i.e. Act VII. of 1969; the Gas Bill retained this obligation. Compared

²⁵Interestingly, the same regulatory rules govern 'cross-boundary' supply in the English/Welsh water sector. See: OFWAT: Increasing Competition in the Water Industry, HMSO (April 1996).

²⁶Section 17(2). Detailed rules on connection charge: 32/1995. (VIII.8.) IKM.

with the UK Gas Act 1986 (see Chapter 1.), the duty to supply was more of a burden in Hungary.

In the UK a request for supply should satisfy a two-tier test: (a) the request must be *reasonable* and (b) a public gas supplier is obliged to give a supply of gas so far as it is *economical* to do so.²⁷

A Hungarian gas distributor might refuse a request for supply if (i) the customer to be connected did not pay the connection charge (see above) or (ii) environmental, nature reserve or building protection authorities refused to issue a construction permit.²⁸ Thus a Hungarian gas distribution might not refuse a request for supply on the basis that the giving of gas supply would not be economical. The Gas Act 1994 refers to external circumstances (e.g. payment of contribution charge; permits) in Hungary. Circumstances of the gas distributor are not taken into consideration: it is irrelevant whether the supply of gas is economical or not. Hence let-out clauses are stricter in Hungary: a gas company in Britain has more grounds to refuse a request for supply than its Hungarian counterpart.

The Hungarian Parliament discussed the Gas Bill in early 1994; the general election was scheduled for May of the same year. The government was keen to get the Bill passed before the elections. Thus there was no time to re-draft the Bill in detail. Yet SHC and investors were so unhappy with price regulation that Section VII on tariffs was amended at the last minute. The main points of the new rules may be summarised as follows:

- Gas tariffs shall be cost-reflective by 31 December 1996;
- Gas tariffs may not discriminate between classes of customers;
- The Energy Office will be responsible for **determining** detailed rules on price regulation. But the Minister of Industry and Trade will **fix** prices in accordance with Act LXXXVII of 1990 on Prices until 31 December 1996;
- Gas licensees may ask the Office to review prevailing prices at any time.

The amendment summarised above raised more problems than it solved: it was not clear (i) what was to be the division of responsibility between the Office and the Minister; and (ii) what would happen after 1 January 1997 - would prices be liberalised or some kind of price control remain in place? As will be discussed under 3.2, these points were in the centre of attention after privatisation.

The Gas Act was passed with the amendments mentioned above on 29 March 1994.

1.6. Conclusion

The gas sector was not ready for privatisation in 1994, although Hungary was working hard on the five problem areas identified above. The government successfully

²⁷Section 9 of the Gas Act 1986.

²⁸Section 20. of the Gas Act 1994.

coped with **import** (point 1.), **company** reorganisation (point 4.), and **legal and regulatory framework** (point 5.); Russian supply was secured, gas enterprises had been re-registered, and new energy Acts were passed. However not much progress was made so far as **tariffs** (point 2.) and **network financing** (point 3.) were concerned. As the next Part will try to show, the unwillingness to address these points left a mark on gas privatisation in Hungary.

Part II.

1995: The year of privatisation

The socialist party won the Hungarian general election in 1994. The change of government had surprisingly little impact on privatisation policy. The new government was not less committed to the disposal of state-owned companies than its predecessor. Thus the irony of the Hungarian energy privatisation is that it was a left-wing government which sold off electricity and gas distributors. Two general comments may be made here:

(i) Political standing does not seem to determine privatisation policy.

Left or right-wing governments may be equally ardent supporters of disposals. If not political standing what else motivates governments to sell off energy companies ?

(ii) Fiscal prudence is the overriding reason for selling state-owned companies.

When the conservative government came into power in 1979 the British economy was "in serious trouble. It had been deteriorating for years, but in the 1970s the decline accelerated."²⁹ The primary objective of the incoming government was to restore financial equilibrium with the minimal increase in taxation. According to Dennis Swann, corporate sell-offs were technically easier and politically more acceptable than any other potential solution.³⁰ C. D. Foster also argues that

... the main motive the Treasury had in marshalling a succession of flotations had been to put continuous downward pressure on net public expenditure and the PSBR.³¹

The same motive was equally important in Hungary: in 1994 public sector deficit was soaring, social security was on the edge of bankruptcy and taxation was stretched to its limits. The new government was willing to consider any option that promised

²⁹John Moore: British Privatisation - Taking Capitalism to the People. In: Her Majesty's treasury Guide to the UK Privatisation Programme (1995), page 63.

³⁰Dennis Swann: The Retreat of the State (1988), pages 226 - 227.

³¹C. D. Foster: Privatization, Public Ownership and the Regulation of Natural Monopoly (1992), page 117.

immediate relief from fiscal troubles. Privatisation was an ideal solution: the Treasury could collect much-needed cash from the sale of state-owned companies straightaway. Thus two fundamentally different political parties (Conservative and Socialist) in two fundamentally different countries (UK and Hungary) came to the same conclusion: privatisation was seen as a new source of income for the Treasury. But privatisation proceeds may not offset budget deficits in the long run: the number of privatisation candidates is limited. Privatisation proceeds may balance the books for some years: the long term fiscal effects of privatisation is a different story. One may argue then that, so far as the fiscal effects are concerned, privatisation was a short term policy both in the UK and in Hungary.

A new privatisation Act (Act XXXIX of 1995) was passed: the two privatisation agencies (State Property Agency and SHC - see point 1.4 above) were merged under the leadership of a new minister. The merged and renamed agency (ÁPV Rt.) was the most successful privatisation body in history of the Hungarian privatisation programme: ÁPV Rt. sold more assets and companies between 1995 and 1997 than the State Property Agency and the SHC did together between 1990 and 1995.

A comparative point should be made here. Every ex-CMEA country set up a privatisation body and adopted a number of Acts on privatisation: sales in Britain were administered without a privatisation agency³² and no 'general' privatisation statute was enacted. John Moore criticised the idea of framework Acts as follows:

Some countries have tried to pass omnibus bills covering the transfer of all state-owned industries to the private sector, but catch-all bills cannot allow for individual provisions and prove to be hopelessly unwieldy in parliamentary terms.³³

While John Moore's argument is correct, it should be remarked that 'catch-all' Acts may be quite useful:

(1) General Principles

A general privatisation Act may lay down some basic principles of privatisation: rules (i) on the evaluation of shares/property, and (ii) on the selections of advisors *via* open tenders are examples. Such principles shall be applicable to ALL future transactions. Thus a 'catch-all' Act may help to achieve a level of uniformity.

³²The Treasury Privatisation Unit co-ordinated sales in the UK; but it is not an independent ministry or agency.

³³ John Moore: *British Privatisation - Taking Capitalism to the People* In: H.M. Treasury: Her Majesty's Treasury Guide to the UK Privatisation Programme (1995), page 71.

(2) If no individual Act, then . . .

It would be naive to suggest that the Parliament passed an individual Act on *every* disposal in Britain. It was mentioned in Chapter 4. that there was no statute covering the sale of the Plant Breeding Institute. Had the UK passed a 'catch-all' statute the lack of specific privatisation Act might not have been a problem: the Department of Education and Science could have consulted the 'general' Act to find out how Estimates and Supplementary Estimates must be prepared.

To conclude, the individual legislation *versus* 'catch-all' bills debate is still going on. While it is correct that 'general' Acts do not allow for individual provisions, there are at least two arguments for passing a framework privatisation statute. The UK rejected the idea of 'catch-all' bills: Hungary passed two general privatisation Acts. Both countries have impressive privatisation track records. The final point may be then that it does not matter whether a general Act or a long list of individual Acts govern the sale of state-owned assets/companies, *provided* that investors trust the legal framework underpinning privatisation.

The Hungarian privatisation agency started to push through the disposal of strategic companies in early 1995. Five priority projects were nominated: (i) MATÁV (telecom); (ii) MVM (electricity); (iii) MOL (oil and gas upstream); (iv) regional gas distributors; (v) and Antenna Hungaria (broadcasting).

The sale of GDCs was conditional upon making further progress on the five problem areas identified above. The following developments happened in 1995:

2.1. Import

Russian contract and Diversification

Hungary continued to foster import links both in the East and in the West. On the one hand, Russia remained the sole importer to the country. MOL signed a major contract with Panrusgaz for the delivery of 4 bcm gas.³⁴ On the other hand, the construction of the HAG pipeline was under way; Hungary was looking for potential options to import gas from Western Europe.

2.2. Tariffs

Price increases and schedule for the future

After a three year break gas prices were put up by 53% in January 1995.³⁵ Furthermore, the Energy Office, the Ministry of Industry and Trade, and the Ministry

³⁴EEER, February 1995, page 19.

³⁵EEER, January 1995, page 6.

of Finance published a consultation paper on future tariff increases. Chapter VIII³⁶ of the Gas Act 1994 set the framework for this proposal: as was mentioned under 1.5, the Gas Act stated that tariffs shall be cost-reflective after 1 January 1997. Having considered the discussion paper mentioned, the government passed a special Decree on the regulation of gas tariffs (Decree 1075/1995. (VIII.4.) Korm). The main points of this Decree may be summarised as follows:

- Wholesale and retail tariffs for natural gas must be increased so as to guarantee that gas licensees could earn an 8% return on capital by 1 January 1997.
- Three waivers of tariff increases were scheduled: (i) on 1 September 1995 an 8%, (ii) on 1 March 1996 a 25%, and (iii) on 1 October 1996 a further, undisclosed price hike.
- Between 1 January 1997 and 31 December 2001 gas tariffs will be set in accordance with an RPI-X - style formula. The formula included (i) a cost pass-through factor and (ii) a so-called 'claw-back' provision: details of this provision shall be discussed in the Conclusion below.

To appreciate the importance of these points it may be useful to recall how prices were set during nationalisation. Chapter 1. has considered pricing policy in the era of nationalisation in Britain. The discussion concluded that (i) the government influenced the timing and level of tariff increases, and (ii) automatic cost pass-through mechanism was not in place. These points are also relevant in the case of Hungary: the only difference is that, unlike in Britain, Act LXXXVII of 1990 on Prices explicitly acknowledged that ministers will set maximum prices for natural gas. It was argued in Chapter 1. that gas boards were empowered to set tariffs under the British nationalisation statutes; but ministers influenced pricing policy informally ("early warning system"³⁷). Hence, as far as ministerial power over price fixing is concerned, the Hungarian legislation was nearer to reality: ministers were authorised to fix energy tariffs in Hungary, while their British opposite numbers exercised powers which were not given them by statutes.

It was also argued in Chapter 1. that utilities are better off after the introduction of the RPI-X price regime in Britain: (i) the timing of price adjustment is known in advance and (ii) certain costs may be passed through to customers.³⁸ The same points also apply to Hungarian gas distributors: under the old price regime (i) gas companies did not know when, and by how much, tariffs would be put up and (ii) changes in the cost of import gas could not be passed on to customers (see point 1.2. above).

³⁶A new Chapter VII was added to the Gas Act, so what was Chapter VII of the Gas Bill (Price Regulation) is Chapter VIII of the Act.

³⁷See Chapter 1., Part I., point A.1. above.

³⁸C.D. Foster: *Privatization, Public Ownership and the Regulation of Natural Monopoly* (1992), page 209.

But in addition to timing and pass-through, a third factor should also be mentioned here: inflation. Hungary is a high inflation risk country. As was mentioned under 1.2 above, the annual rate of inflation was 25.4% between 1991 and 1995; the figure was 24% in 1996.³⁹ Inflation and price hikes were not linked in the past; the government refused to increase gas tariffs between 1991 and 1994, even though inflation was above 20% per annum. Under the RPI-X regime gas tariffs will follow inflation. It is certainly a good news for gas companies operating in a high inflation rate country. Thus the introduction of an RPI-X - style formula had similar consequences in the UK and in Hungary: the new price regime benefited gas companies. And how about gas customers ? While the average household gas bill has fallen in the UK after 1986⁴⁰, it is not clear what Hungarian customers will gain from the introduction of the RPI-X formula: tariffs are set to rise in the medium term. The possibility that the 'claw-back' provision, which was not introduced in Britain⁴¹, will be used is remote: this point will be explained in detail in the Conclusion. The final point here is that gas companies in Hungary are likely to be happier with the new price regulation than their customers.

2.3. Network Financing

Further compensation package to municipalities

The Parliament passed a new Act (Act LXX of 1995) handing over further chunks of gas distribution company shares to the municipalities. Some 955 municipalities acquired a 40% stake in the five GDCs.⁴² The book value of shares handed over to the municipality was HUF 18bn (app. GBP50m). Two issues should be considered here:

- Theoretical problem

Although this piece of legislation was labelled as a compensation Act, it was not entirely clear what municipalities were expected to be compensated for. As was mentioned under 1.3 (i) above, municipality financed pipelines were not transferred to the GDCs free-of-charge after November 1992. Municipalities and GDCs agreed about the ownership of gas assets prior to the construction of pipelines: either pipelines were sold to the GDC or the company charged a service fee for supplying gas through municipality owned pipelines. Why should municipalities be compensated then ? They signed a contract voluntarily, the other party (GDC) fulfilled its contractual obligations, nothing unexpected happened - compensation may not be due.

³⁹The Financial Times: Hungary (supplement), 16 December 1996.

⁴⁰Sir George Young: Speech to World Privatisation Conference. In: Her Majesty's Treasury Guide to the UK Privatisation Programme (1995), page 78.

⁴¹See: Conclusion, point (4)(b).

⁴²EEER, October 1996, page 18.

Hence the handing over of shares to municipalities was not compensation; it was a new technique of local council financing. As a rule, two models exist as to the proportioning of privatisation proceeds between (a) municipalities and (b) the central government. To put it bluntly, either municipalities are entitled to a portion of proceeds or not. Hungary adopted the former model; Britain follows the latter.

As was mentioned in Chapter 4. above, the main rule in the UK is that proceeds shall be remitted to the Consolidated Fund rather than to third parties unless there has been a prior approval of Parliament. Thus the British government does **not** finance local councils from privatisation proceeds directly.

Hungarian municipalities seem to be in a more fortunate position: ever since the passing of the first privatisation statute (Act VII of 1990), local councils are entitled to a portion of privatisation proceeds. Municipality financing in Hungary was in a crisis by the mid-1990s; some councils were in the red. The central government was looking for new ways to finance local councils. Yet no further chunks of privatisation proceeds might be allocated to the municipalities; the Parliament told the SHC that HUF 150bn proceeds shall be remitted to the Treasury in 1995. Hence the privatisation agency did not have spare cash to finance municipalities. An alternative solution was needed: gas company shares from the government's residual holding were handed over to the municipalities free-of-charge. As will be noted below (point 3.3), municipalities sold their shares straightaway and, presumably, used the money to improve their financial situation. One may conclude then that the transfer of GDC shares to municipalities was not compensation but an emergency solution to rescue local councils from bankruptcy.

- Practical problem

Act LXX of 1995 did not set a deadline for the distribution of shares among municipalities. The privatisation agency decided not to hand over shares until after the completion of gas privatisation: it was feared that municipalities holding 40% of the votes would thwart the transaction. The company law question here was whether municipalities were shareholders after the coming into force of the Act or not.

The privatisation agency argued that municipalities were not shareholders; they were not registered in the share registry. The agency could have referred to Professor Pennington's textbook:

Shareholders who are not members are not entitled to attend general meetings, and so holders of letters of allotment and acceptance and holders of share warrants cannot do so unless the articles so provide.⁴³

While this argument is correct in a general sense, in this particular case the 'no one may benefit from her/his own wrong doing' - maxim should have overruled it. The

⁴³Pennington's Company Law (1990), page 633.

privatisation agency *intentionally* delayed the distribution of shares so as to prevent municipalities from being registered as company members. Hence the privatisation agency barred a number of would-be members holding 40% of the issued share capital from taking part in the business of the GDCs. Refusing to hand over shares to would-be members so as to exclude them from company meetings is illegal under the Companies Act of any civilised nation; resolutions passed at general meetings shall be declared null and void. The local court of Szeged City (southern Hungary) ruled so in 1996. The Court annulled the results of an EGM of an electricity company, including the appointment of the representatives of the investor (Electricité de France) as board members.⁴⁴ Yet no further action was taken; Electricité de France and the local council reached an out-of-court settlement.

The case mentioned above was not the least occasion when a Hungarian court condemned the privatisation agency for not handing over shares to the local municipalities. The Budapest Court ruled in May 1998 that the HSC delivered share certificates to Veszprém municipality 'beyond the reasonable time-limit'. The privatisation agency was ordered to pay (i) damages and (ii) penalty interest.⁴⁵ Hundreds of municipalities may bring similar claims now. To conclude, the HSC will pay dearly for not handing over gas company shares to municipalities until after the closing of the GDC privatisation.

2.4. Companies

New Articles of Association

The Articles of Associations of the GDCs were amended before privatisation. A Golden Share was introduced in each company. The reception of Golden Share in Hungary was discussed under Part II. of Chapter 3. in detail. It is sufficient to remark here that the state retained the right to veto certain strategic decisions, like (i) dissolution of GDCs, (ii) amendments to the scope of activities of the GDCs and (iii) redemption of shares. In addition, the holder of the Golden Share has the right to appoint one board member.⁴⁶

Following the registration of Golden Shares with the Companies Court the stake to be sold in each GDC was increased from 25% of the shares to '50% of shares + 1 vote'.⁴⁷ The main point here is that it was the introduction of Golden Shares which made the sale of a '50% + 1 vote' stake possible in Hungary. Had the reception of Golden Shares been aborted, the Hungarian government would have sold minority stakes (not more than 25%) to foreign investors. It was mentioned in the introduction that Hungarian gas privatisation is unprecedented in Central and Eastern Europe: no other government in the region is likely to sell a majority holding in energy

⁴⁴EEER, May 1996, page 3.

⁴⁵Népszabadság, 26 March 1998, page 5. Internet: www.nepszabadsag.hu.

⁴⁶The status of government appointed directors under British law is discussed in Chapter 2., Part III. above.

⁴⁷See Government Resolution 1065/1995. (VII.6.) Korm., point 13.

distributors. One of the reasons for not offering majority stakes for sale in other Central and Eastern European countries is that the legality of Golden Shares is disputed. For example, the government of Slovakia intended to retain Golden Shares in twenty strategic companies; but the high court ruled that the principle of Golden Share is unconstitutional.⁴⁸ Thus the Slovak government will retain a controlling stake in utilities (see Conclusion, point 4./).

2.5. Law and Regulation

Licences issued

The story of the Hungarian gas licences illustrates how difficult it is to transplant legal institutes from one country to another. The Gas Act 1994 intended to introduce a British-style utility licensing regime in Hungary:

- gas transportation and distribution were declared to be activities subject to a licence;
- unlicensed transport and distribution were prohibited; and
- the Energy Office was established to issue (i) gas trading and (ii) distribution licences.⁴⁹

However the Hungarian legislator did not specify the legal status of licences: is a licence an agreement or an administrative resolution ?

In Britain licences are agreements between the regulator and the regulated. C. D. Foster emphasises that the relationship between the state and the privately owned utilities had been regulated in a contract since the time of Gladstone.⁵⁰ Anthony I Ogus writes that "the regulatory system can be envisaged as a long-term contract between the regulatory agency and the monopolistic firm."⁵¹ The most important consequence of the 'licence as contract' approach is that licences (contracts) may not be modified without the consent of the licence holder (contractual party). For example, Section 23(4) of the Gas Act 1986 provides that "the Director shall not make the [licence] modifications without the consent of the public gas supplier". Section 13(1) of the Water Industry Act 1991 reads as follows:

. . .the Director may modify the conditions of a company's appointment under this Chapter *if the company consents to the modifications*.⁵²

⁴⁸Eastern European Monitor, June 1996.

⁴⁹Section 9 of the Gas Act 1994.

⁵⁰C.D. Foster: Privatization, Public Ownership and the Regulation of Natural Monopoly (1992), page 124.

⁵¹Anthony I Ogus: Regulation (1994), page 306.

⁵²Italics added.

Were these rules on the legal status of licences transplanted into Hungary ?

Hungary had no system of energy licensing before 1994. Only state-owned enterprises were involved in the provision of electricity and gas services: the state was the owner, thus licensing would have been superficial. No one licence had been issued in the past, hence the legal status of utility licences was not settled. After the passage of the Gas Act 1994 the Energy Office started to draft the gas trading and distribution licences.⁵³ But the Office was not quite sure what it was expected to draft: a contract or a resolution ? Thus two drafts were circulated in late 1994:

- One draft followed the British tradition; it was a contract between the Energy Office and the licensees. Section 3. of this draft provided that the licence might not be amended without the consent of the licensee (Cf: Section 23 of the Gas Act 1986).
- The other document was an administrative resolution prepared in accordance with the Code on Administrative Procedure. It was drafted on the understanding that the licence might not regulate issues that are not covered under the Gas Act 1994.

It was the Ministry of Industry and Trade which chose between the two drafts. The Ministry concluded that the Hungarian licences were administrative resolutions. The argument run as follows: Section 4(2) of the Gas Act 1994 declares that the Energy Office is an administrative body; all such bodies are subject to the Code on Administrative Procedure; documents issued by an administrative body are administrative resolutions; thus licences are administrative resolutions and not contracts.

While this interpretation is in line with general principles of Hungarian administrative law, a hiccup should be mentioned here:

- Right to amend, modify, or revoke licences

It was mentioned above that a regulator may amend a licence with the consent of the regulated company in Britain; if the regulated company does not give its consent, the matter is referred to the MMC. Yet consent is irrelevant if licences are administrative resolutions. Instead of regulator and regulated, governor and governed are the two parties in the regulatory process. Regulation is not a process of "negotiations of (more or less) equals around a table"⁵⁴ in Hungary. It is the regulator who dictates: the regulated shall obey administrative orders.

Hence the Energy Office in Hungary could amend, modify, or revoke licences at any time without the consent of the licensees. This arrangement may leave licensees at the

⁵³A comparative point: in the UK the Secretary of State drafted the first licences. See: Chapter 1., point 3.2(ii)(a).

⁵⁴C.D. Foster: op. cit., page 275.

mercy of the regulator. Regulated utilities are in a better bargaining position in Britain: licensees are contracts there.

2.6. Conclusion

The international tender for the sale of 'a 50% + 1 vote' stake in each of the five GDCs was issued on 5 August 1995.⁵⁵ It will be useful to summarise what arrangements were in place when the five companies were offered for sale.

1./ Russian gas supply secured and progress with diversification

Hungary managed to secure natural gas supplies both from the East and from the West. On the one hand, Panrusgaz and MOL signed long-term agreements; on the other hand, the HAG pipeline was under construction.

2./ Price regulation reformed

Salient changes happened here: Hungary introduced an RPI-X - style price regulation. Tariffs were increased in 1995. A Government Decree pledged three further waves of price increases. The intention was to achieve cost-reflective price levels by January 1997.

3./ Financing: troubles in the pipeline

Two issues foreshadowed difficulties here: (i) The Hungarian Parliament passed two compensation Acts: municipalities were to hold a 40% stake in the gas distributors. (ii) The gas distribution companies did not own all pipelines in their licensed areas; uncertainty over third-party owned pipelines lurked in the background.

4./ Re-registered companies and Golden Share

Privatisation candidates were Company Act-like companies. The government retained a Golden Share in each of them.

5./ Legal environment and regulation

The new Gas Act was a privatisation-friendly piece of legislation. The Energy Office of Hungary was the first utility regulator in Central and Eastern Europe.⁵⁶ MOL and the GDCs were licensed by early 1995.

⁵⁵The Financial Times, 5 August 1997.

⁵⁶Centre for the Study of Regulated Industries: Utility Regulation 1997 (1997), page 5.

One may conclude then that Hungary successfully dealt with points (1) **Gas import**, (4) **Company re-registration**, and (5) **Legislation and licensing**. The future of point (2) **Price regulation** depended upon the political willingness of the government to increase prices as scheduled under the Government Decree of 1075/1995. Finally, point (3) **Network financing** was in a state of muddle; some municipalities were to receive GDC shares, while others owned distribution pipelines situated within the licensed area of the GDCs. Thus the Hungarian government did not quite find a solution to this problem.

Part III.

Post-privatisation developments

Gas privatisation was not a miracle in Hungary; it did not dispense with the above identified problems at once. Actually, (i) pricing and (ii) municipality investment turned out to be time-bombs which went off after privatisation.

3.1. Import

New gas contracts and diversification

The Hungarian gas system has been further diversified after privatisation: (i) A major gas contract for the delivery of 225bnm gas was executed between MOL and Panrusgaz. This contract covers a period of 20 years.⁵⁷ (ii) The HAG pipeline was completed in September 1996. MOL signed an agreement with Gaz de France for the supply of 0.4bnm gas *via* the HAG pipeline. Ruhrgas also sold 0.5bnm gas to MOL in 1996 (see point 1.1).

3.2. Tariffs

Botched price proposal

The second round of price adjustments was completed successfully: energy prices were increased by 25% in March 1996 as scheduled under the Government Decree (see point 2.2).⁵⁸ However the third round was called off in 1996.

As was mentioned under 2.2, the Government Decree did not specify by how much prices should be increased in October 1996. Hence the exact figures were to be worked out in accordance with Section VIII. of the Gas Act 1994. The Energy Office prepared a recommendation taking into calculation factors like (i) currency devaluation, (ii) import price of natural gas, and (iii) operational costs of the GDCs.⁵⁹ The Energy Office's recommendation was submitted to the Minister of Industry and

⁵⁷EEER, November 1996, page 20.

⁵⁸EEER, March 1996, page 3.

⁵⁹Point 2. of Government Decree 1075/1995. (VIII.4.) Korm.

Trade for approval⁶⁰; and this is where the weakness of Hungarian price regulation lies.

A comparative point may be made here. The Minister is not obliged to accept the recommendation of the Energy Office in Hungary; the Secretary of State might or might not accept the recommendations of the MMC in Britain.⁶¹ Thus in both countries professional bodies (Energy Office or the MMC) submit recommendations to politicians (Minister or the Secretary of State). Naturally, politicians are primarily interested in politics: they might refuse a professionally sound recommendation if party politics so dictates. This is what happened in the case of the National Power/PowerGen bids in the UK (see Chapter 5.); and also in the case of the October 1996 price adjustment in Hungary. The government did not accept the Energy Office's recommendations.⁶² A special committee was set up to investigate whether the Energy Office's recommendations were (politically) acceptable or not.

It is to be recalled that a price proposal was also reconsidered in the UK in the previous year. As was mentioned in Chapter 5. the Director General of OFFER re-reviewed his distribution price paper in 1995. Comparing Hungarian and British experiences with the re-reviewing of utility tariffs two similarities may be highlighted:

- Reaction

Investors reacted exactly the same way in Hungary as they did in the UK. British comments were quoted in Chapter 5. above; investors made the following remarks in Hungary:

We will be doing our best to encourage the government to stick to its promises. What we are seeing here is a government making commitments when it wants to sell something in 1995 and then having different ideas in 1996 when it is trying to be more popular and to win elections. This is simply unacceptable.⁶³

⁶⁰Act LXXXVII of 1990 on prices provides that the Minister of Industry and Trade shall fix the maximum tariffs for gas and electricity, in practice the government had been approving price hikes ever since the passage of the Act on prices.

⁶¹See: Chapter 5., Part III., point (i) above.

⁶²Although 1996 was only the second full business year of the Energy Office, it was the second occasion when the government did not accept the Office's recommendations. The very first price proposal from the Energy Office was also refused in September 1994; a bad omen. See: EEER September 1994, page 14.

⁶³EEER, August 1996, page 2.

- Aftermath

The new distribution price regime was tougher than the August 1994 proposal in Britain, nonetheless it was not tough enough to thwart the Big REC Race. Thus the re-reviewing of the original price proposal had limited impact in the UK: as was discussed in Chapter 5., the RPI-3 price cap did not deter predators from acquiring RECs.

As far as Hungary is concerned, investors actually benefited from the re-reviewing of the original Energy Office proposal. While gas tariffs went up by 18.8% only (the original proposal recommended a 25% hike) in January 1997, investors may be better off in the medium term: the government announced that gas tariffs shall be adjusted **quarterly** in the future. Price adjustments will take into account (i) currency devaluation and (ii) inflation. The point here is that neither the Gas Act 1994 nor the licences provide for automatic price adjustments; the quarterly review was introduced to win back investors' confidence. One may conclude then that the second proposal was quite 'investor - friendly' in Hungary: one moderate hike followed by regular adjustments is better than a sharp price increase without subsequent adjustments.

3.3. Network Financing

Municipality stakes sold

The municipalities did not hold on to their GDC shares. In the case of four companies municipality shares ended up in the hands of investors who purchased the '50% + 1 vote' stakes from the privatisation agency in 1995. As far as the fifth company is concerned, a variety of financial investors purchased up TIGÁZ shares from local municipalities by early 1997. Shares in all the five GDCs are traded on the OTC market of the Budapest Stock Exchange as of today.

Thus the ownership structure of the GDCs was rearranged after privatisation: for the time being certain groups of investors hold a 90% stake (50% + 1 vote acquired from the privatisation agency, plus 40% acquired from local municipalities or at the Stock Exchange) in four GDCs.

The question here is whether the HSC envisaged that investors will try to acquire further blocks of shares from local councils. If YES, what was the official view ?

- If this 'block-building' was seen as 'undesirable' then the transaction documents⁶⁴ should have provided that the Buyer(s) may not purchase additional shares from the local municipalities and/or from third parties.
- If the acquisition of further shares was politically acceptable then the HSC and the local municipalities should have tried to privatise their stakes *jointly*.

⁶⁴The Sale and Purchase Agreement, Articles of Association, and the Shareholders' Agreement.

It is open to debate whether the HSC did consider this issue in detail or not. With hindsight, it would have been better not to allow investors to acquire further blocks of shares. The HSC should have tried (i) to purchase back GDC shares from the municipalities at a reasonable price and (ii) to list GDC shares on the Budapest Stock Exchange. It is regrettable that it was not the HSC but the investors who took the plunge: they purchased up municipality shares in the case of four (out of five) GDCs.

3.4. Companies

Competition and re-transfer of shares

/A/ Competition

Privatised gas distributors operate in an increasingly competitive environment both in the UK and in Hungary.

Liberalisation is the main source of competition for British Gas: the monopoly threshold had been reduced from 25,000 therms per annum to 2,500 therms per annum in 1992 and is due to be abolished by 1998.⁶⁵ Thus the British domestic gas market will be fully liberalised in the near future. The EU is likely to move towards liberalisation once the proposals for the internal market in natural gas has been finalised.⁶⁶

Liberalisation does not play the same role in Hungary: the Hungarian gas sector is not being opened up to competition. As was mentioned under 1.5, Third Party Access was abolished and territorial exclusivity was introduced before privatisation. Nevertheless competition seems to strengthen: new competitors have entered the gas distribution market.

(i) Independent suppliers

The Energy Office did not issue new licences until after the close of GDC privatisation. Potential applicants, mainly municipalities, threatened to bring the Office to court; however the sale of the GDCs was closed before proceedings would have been initiated. The Energy Office appreciated the 'patience' of applicants; licensing policy was reviewed after privatisation. The Office announced that if statutory conditions are fulfilled⁶⁷ licences would be issued *automatically*. As a result, four new suppliers have been licensed during 1996.

(ii) MOL

MOL was excluded from the privatisation of GDCs: the privatisation agency argued that vertical integration was not desirable in the gas sector. The Bidding Rules

⁶⁵See: Chapter 4., Part III.

⁶⁶OJ C 315, 24.10.96., page 18.

⁶⁷Section 9(3) of the Gas Act 1994.

provided that no bidder might be licensed as a Gas Trader in Hungary. At the time of privatisation MOL was the sole Gas Trader; hence this company could NOT bid for GDCs. But this philosophy vanished after privatisation. MOL did enter the downstream market: this company (i) holds stakes in the newly licensed suppliers, and (ii) entices away big industrial customers from the GDCs. Section 4(1) of the Gas Act 1997 (Act XX. of 1997) provides that big industrial customers may be added to the licence of the gas trader, i.e. MOL. Many industrial customers switched to MOL in 1996 - 1997; leaving the GDCs with high cost, low consumption customers (i.e. schools, residential homes).

/B/ Re-transfer of shares

The Hungarian state sold the GDCs on condition that investors shall hold on to their stakes for a period of ten years. The sale and purchase agreements provided that no investor may transfer its '50% + 1 vote' stake in any GDC without the prior approval of the privatisation agency; in addition, the transfer of a 25% or more stake should be approved by the Energy Office under the Gas Act 1994.⁶⁸ Thus the disposal of shares acquired from the privatisation agency is subject to two approvals. Yet investors also hold shares that were acquired from the local municipalities or on the OTC market (see point 3.3 above): the re-transfer of these shares is subject to Energy Office approval only.

French are particularly keen to re-transfer their stakes. Gaz de France [hereinafter: GdF] transferred its '50% + 1 vote' shareholding to a 100% owned subsidiary (GdF International) immediately after closing. The rationale for this transfer was never properly explained. It was rumoured that GdF could benefit from certain tax concessions if a subsidiary (as opposed to GdF) held the GDC stakes.

Two years later GdF was negotiating with ÖMV, an Austrian company, about the transfer of shares in a GDC (ÉGÁZ). The background to this transaction is as follows: ÖMV was keen to acquire ÉGÁZ, a gas company serving north-west Hungary⁶⁹; the Austrian company did not bid for any other GDC. It was a surprise then that the ÖMV bid was a mere \$25,240,000. The '50% + 1 vote' stake was awarded to GdF for a total consideration of \$77,000,000. This bid was surprisingly high; it was more than 400% of the book value of ÉGÁZ. One may wonder whether it is a coincidence that those two companies were discussing the transfer of ÉGÁZ shares in 1996 which submitted the highest and the lowest bids in 1995. With hindsight, both the ÖMV and GdF bids were disproportionate: the former was too low, the latter was too high. However, the average of the two bids is surprisingly near to the value of the second highest bid: Italgas/Snam offered \$49,837,228 (270% of book value), while the average of the ÖMV - GdF bids is \$51,120,000 (276% of book value). Of course, these figures are not sufficient to conclude that an informal agreement was in place

⁶⁸Section 12 of the Gas Act 1994. As was noted in Chapter 5., there is no similar change of control provision in the British electricity legislation.

⁶⁹EEER, July 1994, page 20.

between ÖMV and GdF at privatisation; but the idea of some co-operation cannot be completely discounted.

3.5. Law and Regulation

Gas Act amended

The Gas Act 1994 was amended in 1997 (Act XX of 1997). The main points of the new legislation may be summarised as follows:

- Gas licensees have the exclusive right to supply customers within their licensed areas. No existing customer may switch to a new supplier after the passage of the 1997 amendments.
- No gas pipelines may be constructed in a currently unconnected area until after a gas supplier has been licensed to supply that area. The point here is that local municipalities must appoint a GDC prior to the construction of pipelines. It follows from the first amendment mentioned above that the municipalities might not choose another supplier subsequently.

These amendments fly in the face of liberalisation: customers have no choice as to which GDC may supply them. Thus the 1997 amendments strengthen the monopoly status of the gas suppliers: this is in stark contrast to British gas legislation. Section 7 of the UK Gas Act 1986, as amended, deals with the situation when a new licensee is appointed to supply gas in the authorised area of an incumbent gas supplier. This situation may not occur in Hungary: gas suppliers have the exclusive right to supply customers within their licensed areas. Furthermore, the British gas market is being liberalised. Gas suppliers will have to compete for domestic customers in Britain. Yet Hungarian customers seem to be chained to their existing suppliers under the Gas Act 1994 as amended. Hence Hungarian gas legislation does not seem to progress towards liberalisation for the time being.

Conclusion

Many Central and Eastern European countries consider the idea of extending privatisation to energy *distribution* industries: the Czech Republic, Poland, and Romania are examples. But no actual tenders for sale have been issued as of early 1998. What lessons might Bulgaria, the Czech Republic, Poland, Romania and Slovakia learn from the disposal of the Hungarian GDCs ?

Lesson 1. Import

Russia will remain the dominant supplier in the region. A Russian - local joint venture may be set up in each country to guarantee that there will be no problems with the importing of natural gas from Russia. At the same time, diversification of

supply should not be ignored: Central and Eastern European countries should be encouraged to search for potential Western (as opposed to Russian) partners.

TOPENERGY in **Bulgaria**⁷⁰ and EUROPOLGAZ in **Poland**⁷¹ are examples.

Lesson 2. Tariffs

Gas prices will not be cost-reflective before privatisation. Nevertheless a political commitment (i) to review prices regularly and (ii) to phase out subsidies might assuage investors.

Bulgaria is a classic example here: The World Bank put some pressure on this country to guarantee that gas prices will be linked to (a) inflation and (b) exchange rate changes⁷². Tariffs are supposed to be reviewed regularly.⁷³

Lesson 3. Network financing

If prices are not increased, gas companies will have no sufficient funds to finance capital expenditure programmes. Thus pipelines will be constructed either from bank loans or from municipal money.

Neither of these options is satisfactory.

If banks finance the capital expenditure programmes, then lenders will try to influence future tariff policy. For example, in **Romania** international donors lend on condition that gas tariffs will be increased.⁷⁴

If municipalities help gas companies with the construction of pipelines, then the local councils will claim gas company shares. Hungary and the Czech Republic are examples. The Hungarian story has been discussed under point 2.3 above; municipalities acquired a 34% stake in each gas distributor in the **Czech Republic**⁷⁵.

Lesson 4. Companies

Gas industry should be restructured and gas distributors re-registered as Company Act-like companies prior to their disposals. The introduction of Golden Shares would enable government to offer majority stakes for sale.

⁷⁰EEER, June 1995, page 27.

⁷¹John Leslie: Central European Energy (1996), page 136.

⁷²EEER, August 1995, page 8.

⁷³EEER, November 1995, page 9.

⁷⁴EEER, August 1995, page 22.

⁷⁵EEER, July 1995, page 9.

Romania and **Slovakia** seem to disregard Hungarian experience on this point. The Romanian government is keen to keep ROMGAZ under direct government control; re-structuring and re-registration is not planned for the time being.⁷⁶ Slovakia is to retain a controlling stake in utilities⁷⁷; Golden Shares are declared to be illegal (see point 2.4 above). The **Czech Republic** seems to hold a different view on Golden Shares: the National Property Fund retained a special 'blocking majority' in the gas companies to prevent decisions being passed that might not be in the national interest.⁷⁸

Lesson 5. Law and regulation

A new generation of energy Acts should be passed and independent utility regulation introduced. The relationship between regulators and governments should be spelled out in the legislation: regulators must be decision-makers and not advisors to the government.

Central and Eastern European countries have a long way to go as far as regulation is concerned. Regulatory offices will be set up in **Bulgaria**⁷⁹ and in **Poland**⁸⁰ soon; however they will be advisory bodies to the government with limited scope of independence. This arrangement might not be good enough: Central and Eastern European governments should try to create independent regulatory offices.

These are the main lessons Central and Eastern European countries may learn from the Hungarian gas privatisation. Yet one would remain pessimistic as far as comparative privatisation experiences are concerned. Central and Eastern European countries have no strong comparative tradition: this region was ruled historically either from German speaking countries (Austria or Germany) or from Russia. Thus Central and Eastern European countries compared their legal and economic systems with those of Austria/Germany or Russia; comparison between countries in the region was more the exception than the rule. Why should country 'A' try to understand the legal system of country 'B' when Austria/Germany or Russia will tell both countries what amendments would be 'welcome' ?

Language is another barrier to comparative research. Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia have six official languages; there is no one universally favoured language in the region. Interestingly, Central and Eastern European countries never had a common 'communicating' language: Bulgaria preferred Greek, while others used Latin. For the time being English seems to be the most popular language in the region. The widespread use of this language implies that

⁷⁶John Leslie, op.cit., page 169.

⁷⁷EEER, June 1994, page 11.

⁷⁸EEER, July 1995, page 9.

⁷⁹EEER, February 1995.

⁸⁰EEER, December 1994, page 11.

these countries are inclined to study British/American examples; especially so in the field of privatisation where the UK experience is second to none. Hence one may not rule out that Central and Eastern European countries will try to draw on the privatisation of British Gas (1986); and lessons from the Hungarian gas privatisation (1995) will not be considered.

Annex 1.***Extracts from the Hungarian Gas Act 1994.***

NOTE: This is not, and does not intend to be, a word-by-word translation. Those wishing to consult the full English text may find the *Hungarian Rules of Law in Force*, Nr. V./14. (15 July 1995) useful. This translation attempts to concentrate on the meaning (as opposed to words) of the Hungarian Act. Having that in mind, unnecessary details have been omitted; and only those sections have been translated to which references are made in the main text.

Section 4.**The Hungarian Energy Office**

- (1) The Hungarian Energy Office [hereinafter: the Office] shall be in charge of (i) the licensing of gas supply and gas trading activities, (ii) the monitoring of consumer satisfaction and of the level of services, and (iii) customer protection.
- (2) [. . .] The Government may give directions to the Office. The supervision of the Office shall be the responsibility of a minister nominated by the Government.

Section 6.

- (1) The Office shall
 - a) issue and, where the Act so defines, amend the gas supply and gas trading licences [. . .];
 - b) approve business codes prepared by the licensees. Opinions of consumer protection agencies shall be taken into account in approving such codes;
 - c) define the scope of business information gas suppliers and traders will be obliged to publish;
 - d) [. . .]
 - e) prepare recommendation in connection with (i) prices, [. . .] and (ii) rules governing the calculation of connection charge.

Section 11.**Licence Modification [. .]**

- (1) Licences may be modified at the request of the licensees in the case of substantial changes in the circumstances.

Section 12.**Demerger, Merger, Consolidation, Reduction of Capital**

Licensees may not (i) demerge, (ii) merge or (iii) be consolidated with another business organisation without the approval of the Office. The consent of the Office is also necessary to (iv) the transfer of a substantial stake in a licensee; furthermore (v) licensees should obtain the approval of the Office before making an application to the court in connection with the reduction of capital.

Section 17.**Construction of Gas Distribution Pipelines**

- (1) [. .]
- (2) Potential new customers shall pay a connection charge in respect of construction costs not covered by the official gas tariffs. The minister shall determine the amount of connection charge payable.

Section 20.**Obligation to Supply**

- (1) The gas supplier is entitled and obliged to supply gas [within the area defined in its licence] continuously and safely.
- (2) [. .]
- (3) The gas supplier may be exempted from the obligation to give a supply of gas, if (i) a potential new customer does not undertake to defray the connection charge levied, or (ii) approvals concerning environmental, nature reserve, listed buildings, or other matters have not been granted and the lack of such approvals prevents the gas supplier from giving a supply. [. . .]

Section 21.**Public Utility Contract**

- (1) [. .]
- (2) As from the date of the public utility contract the public gas supplier is obliged to give a supply of gas continuously, while the customer is obliged to pay for the gas consumed.

Section 31.**Price Regulation**

- (1) Production, resale, distribution, and supply tariffs for gas shall include factors like (i) necessary investments costs, (ii) operational costs incurred by a licensee run efficiently, and shall provide for (iii) a profit margin necessary for the long term operation of licensees.
- (2) [. . .]
- (3) The Office shall work out detailed rules concerning price determination and price setting. The minister shall fix prices and shall publish prices so fixed in a ministerial decree. [. . .]

Annex 2.

Glossary of terms

ÁPV Rt. (Állami Vagyonkezelő Rt.)	Privatizációs és	A new privatisation agency; set up in 1995 after the merger of the State Property Agency and SHC.
CMEA		Council for Mutual Economic Assistance; established in January 1949 and abolished in 1991.
GAZPROM		The biggest gas company in Europe, registered in Russia.
GDCs		Five regional gas distribution companies in Hungary: ÉGÁZ, DDGÁZ, DÉGÁZ, KÖGÁZ, TIGÁZ.
HAG		Hungary - Austria Gas Pipeline connecting Hungary to the West European gas network.
Italgas/Snam		An Italian consortium tendering for Hungarian gas distribution companies; it is the owner of TIGÁZ for the time being.
MOL (Magyar Olaj- és Gázipari Rt)		Hungarian Oil and Gas Company; the sole gas trader in Hungary and the biggest gas company in the country. MOL shares are listed on the Budapest Stock Exchange.
ÖMV		The main Austrian gas and oil concern.
PANRUSGAZ		A Hungarian - Russian joint venture; established in 1994.
SHC (State Holding Company)		A privatisation agency in Hungary; established in 1992 to manage 'permanently' state-owned assets; merged into ÁPV Rt. in 1995.
State Property Agency		A privatisation agency in Hungary; established in 1990 merged into ÁPV Rt. in 1995.

Conclusion

One may wonder now whether it is not too early to sum up the above discussion. Those who are interested in privatisation generally may argue that this thesis is seriously incomplete: important issues have been ignored, while other topics have not been analysed exhaustively. Both of these charges were correct *IF* this thesis would intend to be a general treatise on privatisation. But that is not the case here. As was mentioned in the Preface, the scope of this thesis is limited: the above discussion has concentrated on the disposal of public utilities (a) in the UK and (b) in Hungary. Bearing in mind that point, this Conclusion would present the following concluding remarks:

- (1) Legal institutions central to the running of utilities were not reformed at privatisation

Chapter 1. has argued that one should not approach privatisation as if it would be the antithesis of nationalisation. So far as the regulation of public utilities is concerned, privatisation was not a fresh start: quite the contrary, the draughtsmen of privatisation statutes copied provisions on (a) Availability of Services and (b) Consumer Protection from the nationalisation Acts. For example, Section 4(1) of the Gas Act 1986 (obligation to supply) is identical to Section 1(1)(9) of the Gas Act 1948. The legal standing of consumer protection agencies under the nationalisation and privatisation statutes is fairly similar. How may privatisation be a revolutionary new idea if certain legislative provisions were copied from an 'outdated' piece of legislation?

Compared with nationalisation, the post-privatisation tariff system is a novelty. As a rule, tariffs are set in accordance with a formula. Should one welcome the introduction of the price formulae?

It should be recalled that, according to privatisation propaganda, the new regulatory regime is supposed to protect the customer. And what is happening in real life? As was argued in Chapter 1., it is questionable whether **customers** are better off under the new price regime: what difference does it make whether (a) prices follow inflation or (b) utilities, with the prior approval of a minister, fix tariffs? So far as customers are concerned, the key point is whether telecommunication, electricity, gas etc. charges will be increased or not. Thus customers will be happy with the RPI-X system if, and so long as, utility prices continue to fall. According to the Centre for the Study of Regulated Industry, tariffs are set to fall *in real terms* until the end of the century in the UK.¹ And how about after the year 2000? It would be naive to suggest that inflation is dead and buried in the UK. The RPI index may start to surge in response to a major war (e.g. Iraq) or the failure of the EMU; and customers will notice that the RPI-X price regime does not quite protect them.

¹ Centre for the Study of Regulated Industry: Performance of the UK Electricity Industry since Privatisation (1997?), page 3.

On the other hand, **utilities** have at least two reasons to prefer the 'RPI-X' - system to the *ad hoc* pricing mechanism of nationalisation: (a) the timing of price reviews is fixed in advance; and (b) certain costs may be passed through to final customers. Thus the RPI-X regime seems to protect utilities: consumer protection seems to be an issue of secondary importance.

To conclude, the following points should be highlighted:

- Three legal institutions are vital to the operation of public utilities: (a) price regulation; (b) availability of services; and (c) consumer protection.
- Out of the three institutions mentioned, two were not reformed at privatisation in Britain. The legislator 'borrowed' rules on the obligation to supply (point (b) above) and consumer protection (point (c) above) from the nationalisation Acts.
- Price regulation (point (a) above) has been revolutionised. Yet utilities and their customers do not share the benefits of the new tariff regulatory regime: it is the utility which has reasons to prefer the RPI-X formulae to the 'old' system of *ad hoc* pricing.

(2) The odd one out - water

This thesis has concentrated on four sectors: electricity, gas, telecommunication, and water. Considering the four sectors listed, water is the odd one out. There are four reasons for arguing that water projects are fundamentally different from the sale of electricity, gas, or telecommunication companies:

- **Municipalities** - Out of the four industries mentioned above, water is the most closely linked to local municipalities. As a main rule, water and sewage assets are often municipality owned - Scotland, Hungary (until privatisation in 1996), and England (until 1 April 1974²) are examples. It was noted in the Preface that the electricity, gas, and telecommunication industries were in public ownership by the late 1940s. Nationalisation cut off the 'municipality-link' in these sectors: while local councils retained certain consumer protection functions (see Chapter 1., Part I., point A.3), municipality ownership *per se* disappeared in the electricity, gas and telecommunication industries both in the UK and in Hungary. By contrast, local councils were claiming that they had certain ownership rights over water related assets as late as 1990.³

In addition to ownership, local authority functions should also be examined in the water sector. As a rule, municipalities have statutory duties under the Water Industry Act 1991: (i) duties in relation to water quality,⁴ (ii) remedial powers in

²Coming into force of (i) the Local Government Act 1972 and (ii) the Water Act 1973.

³See *Sheffield City Council v. Yorkshire Water Services Ltd. and another and related actions* (Ch.D.) [1991] 2 All ER 280.

⁴Section 78 of the Water Industry Act 1991.

relation to private suppliers,⁵ and (iii) duties where piped supplies are insufficient or unwholesome⁶ are examples. Hence municipalities are heavily involved in the provision of water services today: the same level of municipality involvement would be impossible in the case of the other utility sectors.

- **Social obligation** - It was argued in Chapter 1. above that public utilities must discharge certain social obligations: they (i) must provide services upon request, (ii) may not discriminate between urban and rural customers, etc. The 'Obligation to supply' point is especially important in the water sector. As a publication from Cameron McKenna, the well-known City law firm, remarks, "Water is life: indeed, access to water resources is considered in many countries a fundamental human right."⁷ There is a problem here: the construction of water infrastructure is quite expensive.

The following practical points should be remembered: (i) A potential new customer will be connected to two mains: (a) water and (b) sewage; two sets of pipes per customer shall be laid. (ii) Compared to gas pipes or electricity cables, water and sewage pipes are bigger in diameter. Hence the laying of water pipes is slow and rather labour intensive. and (iii) Unlike in the telecommunication sector (optic cables; cordless connection; etc.), no revolutionary new technology seems to be available in the water industry.

According to the World Bank, water companies will spend USD 600 - 800 billion on infrastructure projects between 1995 and 2004.⁸ Who will fund these projects?

- **Water charge** - The logical solution would be if water companies were to finance construction projects from revenues collected from existing customers. But this is certainly not the case in many European countries. Ireland is the best example: according to a survey published by the EU, certain groups of customers are NOT billed in Ireland. Domestic water seems to be free-of-charge in Dublin; customers pay for water in rural areas. The competent minister of the Irish government remarked that no nation-wide water charges may be introduced in the foreseeable future.⁹

Scotland is another example. The so-called Council Tax includes water and sewage charges for the time being. Certain categories of residents, including students in full time education¹⁰, are exempt from Council Tax: hence students do

⁵Section 80 of the Water Industry Act 1991.

⁶Section 79 of the Water Industry Act 1991.

⁷Cameron McKenna: A Guide to Our Legal Services - Water (1997), page 1.

⁸Source: Cameron McKenna: op. cit., page 1.

⁹Nepszabadsag: 20 April 1998. <http://www.nepszabadsag.hu>.

¹⁰The term 'full time education' has given rise to difficulties. According to the University of Edinburgh, Ph.D. students in their fifth year of research are NOT in full time education. It is regrettable that the University has constructed the term 'full time education' in a way that certain

not pay for water in Scotland. Would the same arrangement be acceptable in other sectors ? Certainly not: the notion that customers will be charged cost-reflective prices is a well established principle in the electricity, gas, and telecommunication industries. There is NO cost-reflective pricing in the water sector.

- **Competition and Regulation** - This point has been covered in Chapter 4. It has been argued there that the provision of water and sewage services is the least competitive among all the utilities. It is sufficient to note here that, unlike in the electricity, gas, and telecommunication sectors, increased competition is NOT an issue in the water industry. Hence competition will NOT replace regulation in this sector: unlike OFFER, OFGAS, and OFWAT, the Director General of OFWAT will set charges for many years to come.

The final point here is then that water privatisation is a 'special case'. As a rule, it is easier to sell off electricity, gas, and telecommunication companies, than water boards. This is the reason why both the UK and the Hungarian governments privatised **telecommunication** (year of privatisation: 1984 in Britain, 1994 in Hungary) and **gas** (year of privatisation: 1986 in Britain, 1995 in Hungary) companies first, while the disposal of **water** companies was deferred. Other European countries also followed the same 'timetable': telecommunication companies were the first (and perhaps the only) utilities offered for sale in Germany, France, Moldavia, etc.; the disposal of water companies may follow in due course. Why telecommunication first ? and why are water companies the last utility candidates to be privatised ? It is one of the main themes of this thesis that the '*basic need*' test determines the order of utility projects: the 'more' basic a given utility service is, the later it will be offered for sale. Electricity, gas, and water are deemed to be more 'basic' services than telecommunication: one may live without telephone lines and Internet (Value Added Network Services). But gas and electricity are 'basic necessities' and 'water is life'. Hence telecommunication companies will be sold first; the privatisation of electricity and gas may follow; while the sale of water companies is likely to be the last utility project in any given country in Europe.

(3) Transplantation of privatisation - difficulties in the pipeline

The privatisation of the UK utilities sector has been completed by the mid-1990s. British investors and their advisors should look abroad to find new utility projects: Central and Eastern Europe may be one of the target regions. How British privatisation techniques may be adapted to local circumstances in that part of the world ?

To illustrate the kind of difficulties one may encounter, it is sufficient to refer to the RPI-X price formula discussed under point (1) above. Linking utility tariffs to inflation

post-graduate students are liable to Council Tax. If not the University who will protect the 'gown' from the 'town' ?

may be a straightforward exercise in the UK and in Western Europe generally: inflation is under control there. The RPI-X formula may be introduced then in any of the fifteen EU countries. And how about Central and Eastern Europe? Countries of the former 'Soviet' block are 'advised' to put in place an RPI-X-like system as soon as possible. The introduction of price tariffs is seen as a precondition to successful privatisation. There is a practical difficulty here: can utility tariffs follow inflation if the annual average rate is 1,568.0 % (Uzbekistan, 1994) or 992.0 % (Turkmenistan, 1996) or 100.0 % (Belarus, forecast for 1998)¹¹? The point here is that the 'transplantation' of the *British* model of privatisation may run into practical difficulties in *Eastern* (as opposed to Central) Europe. Hence the original design should be reconsidered taking local circumstances into consideration. There is no doubt that the transplantation of British/Western techniques to non-Western countries is not a simple exercise: clients and their advisors must work together to find a solution which is acceptable to both *Western* investors and *Eastern* customers. How should this process of 'transplantation' be managed?

(4) General notes on transplantation

It would be useful to make two general points at this stage:

(a) One objective

Central and Eastern European governments, unlike their British counterpart, do not seem to pursue a 'trilogy' of objectives (See: Chapter 4.): the main goal there is to balance the books. As a rule, the 'maximizing revenue' objective is the number one priority in Central and Eastern Europe. This is not to say, of course, that issues like (i) widening share ownership or (ii) improving economic performance may not appear in privatisation propaganda. Central and Eastern European governments should 'sell' the idea of privatisation to the public: ministers and presidents might refer to British/Western examples to illustrate how 'great' privatisation is. Yet the idea of 'shareholder's democracy' may be illusory in countries like Belarus:

- As to democracy:

There is an authoritarian president who is loath "to give up any of the prerogatives of power." The Council of Europe did not invite Belarus to its October 1997 summit "because of Minsk's [capital of Belarus] human rights record."¹² Hence democracy may be missing from the political agenda in that country for years to come.

¹¹Source: Business Central Europe: The Annual 1997/98 (December 1997), page 65.

¹²Business Central Europe: The Annual 1997/98 (December 1997), page 47.

- As to small shareholders:

Average monthly wage was \$300 in Belarus in 1997, while annual inflation was in the region of 80%.¹³ How many 'Sids' are there then ready to participate in so-called 'small investors' programmes'? Would a reasonable (wo)man subscribe for utility shares under these circumstances?

To conclude, there is a simple reason for selling state owned companies in Eastern Europe: privatisation is a means of trying to balance the books. It is the 'maximizing revenue' objective which carries the day there: references to other objectives, like shareholders' democracy or improving economic performance, are window-dressing.

(b) Learning from mistakes

Those working on the 'transplantation' of privatisation to the less developed areas of the world should remember that certain projects did NOT live up to expectations in Britain. The privatisation of British Gas plc. (Chapter 4.), and the retention of time-limited Golden Shares in the water and electric industries (Chapter 5.) are examples; further projects of this kind have been mentioned in Chapter 4. If possible, such mistakes should be avoided in countries which try to follow the British/Western examples. It is of special importance then that (i) 'less successful transactions' should be identified and (ii) reasons leading to the failure of a particular privatisation proposal should be analysed in detail.

For example, the Hungarian government was advised to insert so-called 'claw-back provisions' into the utility tariff formulae in 1995. It should be noted that there was no similar arrangement in the UK gas sector in 1986 (i.e. the year of British Gas flotation). The main point of the Hungarian arrangement may be summarised as follows:

gas companies earning a pre-tax profit in excess of 12% of an adjusted equity base (as defined in the Decree)¹⁴ are obliged to rebate 50% of that excess profit to their customers.

On the face of it, it is the customer who will benefit from the 'claw-back' arrangement: 50% of the excess profit shall be rebated to her/him. In practice, however, utilities see the 12% figure as the upper limit of 'politically acceptable' profit.

Furthermore, one may not rule out that financial reports will be presented in a way that pre-tax profit will be less than 12% of the adjusted equity base: auditors may advise regulated utilities what book-keeping tricks are available to achieve that goal. Thus pre-tax profit will not exceed 11.99%. And this is not the only problem with

¹³Ibid, page 65.

¹⁴Government Resolution 1075/1995. (VIII.4.)

'claw-back' arrangements: the whole idea of rebating excess profit to customers is ill founded. The Director General of Water Services has emphasized in a submission to the UK government that

. . . a formal profit-sharing mechanism [i.e. claw-back provision]
would blunt incentives on companies to reduce costs.¹⁵

The same point is valid in Hungary: it would be rather embarrassing for utilities if tariffs collected in business year 19X7 were to be rebated to customers in 19X8. Hence the existence of claw-back mechanism may discourage companies from seeking ways to reduce operational costs.

To conclude, claw-back provisions do not seem to work in Hungary: they do NOT protect the interests of utility customers. This point should be taken into account when privatising the Russian, Slovakian, Rumanian etc. electricity and gas distribution networks. This is why 'learning from mistake' is essential to the success of the transplantation of privatisation.

(5) The process of transplantation

The simplified summary of the process of 'transplantation' would be as follows:

As a first step, investors and their advisors should mull over the history of the relevant privatisation projects in the UK and/or in Western Europe. A long list of questions that were never properly answered may be raised here: what was the reason for selling the UK natural gas sector as a *de facto* monopoly (Chapter 4.) ? Why was the English and Welsh electricity industry restructured prior to privatisation ? and why was the Scottish electric industry NOT restructured (Chapter 5.) ? In addition to these 'never-answered' questions, it is crucial to pay attention to post-privatisation experience: Why are there so many non-British owned regional electricity companies in the UK today ? Was the introduction of time-limited Golden Shares a good idea ? (See Chapter 5.) Having analysed (i) the 'never answered' questions and (ii) post-privatisation experience one may move on to the next stage of 'transplantation'.

The second step is to form a view about the overall 'success' of the relevant British/Western projects. As was argued in Chapter 4., evaluating privatisation deals is not an easy task. As a main rule, the UK government refrained from setting out 'performance targets'; it is hard (if not impossible) to determine what privatisation was actually supposed to achieve. Three 'core objectives' have been identified in Chapter 4.: (a) maximizing revenue; (b) extending share ownership; and (c) improving economic performance. But which was the number one priority ? So far as the (i) Plant Breeding Institute; (ii) the coal and nuclear industries; and (iii) the trust ports are concerned, it is beyond doubt that objective (a) was of secondary

¹⁵ Util. Law. Rev., 9(1) Jan - Feb 1998, page 21.

importance: HM Government did NOT maximize revenue from the sales mentioned. Turning to objective (b), it is open debate whether privatisation has really extended share ownership in Britain. There was a sharp increase in the number of shares owned by first-time investors immediately *after* the British Petroleum, British Telecom, British Gas etc. flotations: the *longer term* trend is a different story. As a main rule, Sid tends to get rid of her/his shares: the reasons for this have been explained in Chapter 4. The main point here is that privatisation did not change the basic pattern of shareholding in Britain: institutional investors do control privatised utilities, while the millions of 'Sids' may be referred to as debentureholders. Thus if the intention behind the flotation of so many British utilities was to introduce 'shareholder's democracy' then privatisation has certainly failed in Britain.

So far as government intervention is concerned, the final verdict on the success of privatisation would be disappointing. The starting point here is that privatisation was meant to reduce the level of government interference in the UK economy. Chapter 2. has tried to argue that ministerial intervention did not actually disappear in Britain. The style of interference changed, the most likely reasons for interference changed, but governmental 'control' as such lingers on: the 'coal-crisis' of late 1997 is an excellent example.¹⁶ The UK government 'asked' the electricity generators to purchase British (as opposed to import) coal so as to save the coal industry from bankruptcy. The irony of this story is that these are recently privatised industries: the coal and the electricity sectors were sold off in 1991 and in 1995 respectively. The government of the day argued that the sale of electricity generators and coal pits will block political meddling with business decisions. The latest developments seem to contradict that promise.

Perhaps the best approach would be to accept that political interference will not fade away: irrespective of the political standing of a government, the executive will keep an eye on public utilities and other industries of national importance (e.g. the Rolls-Royces, the British Aerospace, etc.). Should political conditions so demand, the government will not hesitate to interfere. The Hungarian electricity and gas sectors are examples. The Hungarian government 'told' the country's privatised electricity and gas companies that tariffs 'might' not be increased in the first quarter of 1998. There was a rather simple reason for not adjusting energy tariffs to inflation (see Chapter 6.): the next parliamentary elections were scheduled for May of the same year.

The final point here is then that privatisation did not 'break the political link'. Both the British and the Hungarian governments interfere with the operation of privatised utilities. Compared with the age of nationalisation, the style and method of 'interference' changed: the very idea of government control remained intact. It might be unfortunate then if Western investors would ask Eastern European governments to pledge not to interfere with the running of utilities after privatisation. Such a 'request', sometimes framed as a precondition to bidding, is beyond the limits of transplantation; it is an extra requirement no EU government could satisfy.

¹⁶The Financial Times, 14 December 1997.

To conclude, it is important NOT to ask Eastern European countries to do more than the UK/Western countries did actually achieve at privatisation: raising extra-conditions is not transplantation.

Finally, the third step is to transplant British/Western privatisation techniques into a foreign legal system. Golden Shares, RPI-X formulae, flotations on local stock markets are examples. This work presupposes a high level of comparative knowledge. As a rule, the legal system of the vendor countries will not be similar to that of the UK/EU. Prior to 1945 Central European countries (Poland, the Czech Republic, Slovakia, and Hungary) were members of the 'Romano - Germanic'¹⁷ family. Russia and Eastern European countries had different legal traditions. The victory of 'communism' in that part of the world led to the emergence of a new legal family: the Socialist Laws.¹⁸ After the collapse of the 'Soviet block' Central European countries went out of their way to re-join the 'Romano - Germanic' legal tradition. This process was particularly successful in the Czech Republic, Hungary, and Poland: these countries have been invited to join NATO in 1997 and may become members of the EU by 2005. So far as Russia and other Eastern European countries are concerned, the story of 'Europeanisation' is more complex: with the exception of Estonia¹⁹, NATO and EU talks might not bear fruit for years to come.

What legal families do Central and Eastern European countries belong to? Socialist Laws? or Romano - Germanic family? or neither of them?

Comparative lawyers refer to Scotland and South Africa as 'mixed systems': the laws of these countries contain both (a) Common Law and (b) Romano - Germanic elements. Central and Eastern European countries are also members of the 'mixed' legal family, although in a different sense: two legal cultures, namely (a) Socialist Laws and (b) Romano - Germanic Laws, are mixed here. In the case of Central Europe, group (b) has already surpassed group (a) in importance: the Czech Republic, Hungary, and Poland are keen to pass as many EU-conform Acts, Orders, Decrees etc. as possible. So far as Russia and Eastern Europe are concerned, remnants of Socialist Laws are of special importance for the time being. Areas like tax law, socialist security, national defence are examples.²⁰

The fact that there are mixed legal systems in Central and Eastern Europe may impede the transplantation of utility privatisation; and this is for the following reasons:

¹⁷The major legal families of the world have no universally accepted titles: different comparatists may use different titles. This Conclusion follows the classification of Professor Rene David. See: Rene David and John E.C. Brierley: *Major Legal Systems in the World Today* (Stevens & Sons) 1985.

¹⁸For a detailed discussion on Socialist Laws, see: Rene David and John E.C. Brierley: *op. cit.*, Part Two.

¹⁹Business Central Europe: The Annual 1997/98 (December 1997), page 42.

²⁰Business Central Europe: The Annual 1997/98 (December 1997), page 32.

- As a rule, the governing law of most UK privatisation projects was English. England and Wales belong to the 'Common Law' legal family: but countries attempting to draw on British experience have 'mixed' legal systems (i.e. a mixture of (a) Socialist Laws and (b) Romano - Germanic Laws). There is a problem here. Comparatists are well aware of the fact that legal techniques that work perfectly well in the Common Law world might fail in a Romano - Germanic country. Trust is an example. As Professor Rene David notes, the concept of trust is "unknown to the Romano - Germanic system"²¹; hence continental lawyers may not understand the debacle of the sale of the trust ports in Britain.²² The point here is that some legal institutions of the Common Law system might not be transplanted into the Central and Eastern European region. The mixed systems of these countries may not be ready for the reception of certain institutions like trust, floating charge, certiorari etc.
- The laws of the Eastern and Central European countries are in a transitory phase: they are made up of a mixture of 'old' (Socialist) and 'new' (EU-like) laws. A long list of fundamental statutes, including the constitution and the civil code, has been amended more than once after the collapse of the 'communism'; and a number of brand new Acts (Companies Act, Stock Exchange Act, and the like) have been passed. As a rule, legislators are keen to break with 'old' legal tradition. The new Hungarian Gas Act is an example. It was mentioned in Chapter 6. that the new Gas Act was passed in 1994. Section 34(3) provides that after the promulgation of the new statute Act VII of 1969 on Gas Energy shall cease to have effect.²³ The setting aside of the 'old' piece of legislation gave rise to difficulties in the run up to privatisation: (i) there were no reported cases discussing the interpretation of the 1994 Act; and (ii) neither the regulator nor the regulated utilities were quite sure about the meaning of certain statutory terms. For example, Section 9(3)b) provides that licensees shall have sufficient funds to pay for at least one quarter of the total gas sold per annum. This provision turned out to be incomprehensible. If the legislator tried to say that a gas company selling gas worth of \$100 per annum shall have \$25 in cash in the fund, then no Hungarian gas entity could have been licensed: no one would-be licensee had this kind of cash cover, unfortunately. Hence the Hungarian Energy Office and the Ministry of Industry and Trade agreed that Section 9(3)b) shall be ignored in licensing gas companies. Some potential investors were not particularly happy with this solution.
As an alternative to passing a brand new Act, the Hungarian legislator could have 'updated' the 1969 Act. For example, the Energy Act of 1935 is in force in Germany today. Of course, this Act has been amended several times; but the original statute has NOT been replaced. A further source of trouble is that new

²¹Rene David and John E.C. Brierley, *op. cit.*, page 347.

²²See Chapter 4., point 4.4. above.

²³Hungarian Rules of Law in Force, Nr. V. V./14.

institutions have emerged in Central and Eastern Europe (e.g. constitutional courts²⁴), while some legal forums (e.g. Central Supervisory Committee in Hungary, a kind of nation-wide consumer protection agency) disappeared. Hundreds of government and ministerial decrees have been passed and/or repealed. The end result is chaos: it is not always easy to find out what legal rules are in force. Thus UK/EU techniques of selling state-owned utilities should be transplanted into a legal environment which is anything but stable and settled for the time being.

- And finally, a few words on courts. As was mentioned in Chapter 4., there were surprisingly few cases concerning the sale of state-owned assets/companies in the UK. Leaving aside **Ross v. Lord Advocate (H.L.) 1986 S.L.T. 603** and **Sheffield City Council v. Yorkshire Water Services Ltd. and another and related actions (Ch.D.) [1991] 2 All ER 280**, there were not many high profile litigations. The reasons for the lack of reported cases have been explained in Chapter 3. It was also argued there that the British courts are reluctant to be involved in the regulatory game. Judges see themselves as 'football referees'; they would interfere with the regulation of public utilities if rules of the game have been breached. Thus applications for judicial review seeking to impugn regulatory orders are few and far between. Turning to Central and Eastern Europe a completely different picture would emerge. As a main rule, judges seem to be quite willing to supervise the privatisation and regulation of public utilities. It is not unusual that opposition parties and/or municipalities refer a privatisation proposal to the Constitutional Court for review. Regulatory orders are also challenged before the courts in Central and Eastern Europe: as was mentioned in Chapter 3., a Hungarian court ruled in 1996 that certain road toll charges are excessively high.²⁵ The comparative point here is that legal institutions and rules may be transplanted from one legal system into another: legal traditions do NOT transplant well. Members of the newly established Constitutional Courts in Central and Eastern Europe were university professors or politicians yesterday; they are judges today. What seems to be missing in that part of the world is legal tradition. Constitutional Courts have no well-established practice as to how applications for review should be handled. It is alarming bearing in mind that these Courts have the power, among others, to suspend privatisation deals. As was mentioned in Chapter 3., Constitutional Courts are surprisingly powerful judicial bodies in Central and Eastern Europe: they may declare Bills or Acts of Parliament unconstitutional and/or may order the executive to legislate on this or that issue. The idea of courts (i) ruling on the validity of Acts or (ii) telling the government how to legislate might shock lawyers educated in the Common Law world. As to (i): It was discussed in Chapter 4. that a British court may NOT declare an Act of

²⁴The regrettable consequences of setting up a Constitutional Court in Hungary has been discussed under Chapter 3., point 3.1.

²⁵Other examples: [1992] Euro C.L.Y. 1916., and 1924.

Parliament invalid. For example, once an Act has been passed on the disposal of public utility X in Britain, there is no legal barrier to offering shares in X for sale to the public. As to (ii): Sir Robert Megarry V-C was quoted in Chapter 3. saying that policy issues are matters for decision by the executive, and not by the courts.²⁶ Simon Brown LJ emphasized in **R. v. Ministry of Defence, ex parte Smith and other applications (H.L.)** [1995] 4 All ER 427 that judges are to “remain within their constitutional bounds and not to trespass beyond them.”

To conclude then, the courts do supervise privatisation deals in Central and Eastern Europe. Common Law lawyers should be prepared to see that the transplantation of UK/Western privatisation techniques may be challenged before the local courts. Hence litigations may delay utility disposals in the Central and Eastern European region.

There is little doubt that the next ten years will be the decade of utility privatisation and liberalisation: EU and non-EU countries will offer more utilities for sale than ever before. This thesis has tried to analyse how the two pioneers of this European-wide privatisation and liberalisation movement (i.e. the UK and Hungary) reformed their utility industries. Hopefully other EU and non-EU countries will follow suit before long: there is no alternative to utility privatisation and liberalisation in Europe.

²⁶*Estmanco Ltd. v. Greater London Council (Vac. Ct.)* [1982] 1 W.L.R. 2, at 7-H.

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Appendix 1.

GENERAL

ANY AND ALL? Future of Social Obligations

Introduction: social contract in the past

The history of social contract seems to be less troubled than in its present or, indeed, its future. In the past, nationalised utilities could have operated as truly natural monopolies. For example, area boards were the sole suppliers of electricity and natural gas in the United Kingdom. Other utilities could not supply, for example, gas "except with the consent of the [British Gas] Corporation and in accordance with such conditions as may be attached to that consent".¹ If British Gas had chosen to select new customers on the basis of some economic criteria ("cherry picking"), who would have supplied customers whose request for gas supply was refused? Hence, monopoly rights came with the requirement that Boards "had to provide a service to all"² (universal services). As a rule, nationalised enterprises had statutory *monopoly* status, but were expected to discharge *social obligations*, including the obligation to provide universal services. This was the original model of the *social contract*.

This article will analyse how the main elements of the social contract in the utilities sector (universal services and monopoly status) changed after privatisation. The discussion will concentrate on the obligation to provide universal services under British law. The domestic arrangements will be related to the EU position towards the end of the article. This article will argue (1) that privatisation abolished monopoly rights but did not amend the obligation to supply customers, and (2) that existing supply obligations will be reformed in the run up to the liberalisation of EU telecom and UK energy markets.

Universal services

As a rule, universal services were never universal; the obligation to provide services to all was subject to statutory exceptions. Dunn J introduced a non-statutory exception in *Woodcock v South West Electricity Board* [1975] 1 WLR 983 in holding that supply

obligations did not extend to unlawful occupiers. A request for supply could be refused only if it failed to satisfy a two-tier test: the *request for supply* had to be reasonable; and the *provision of services* had to meet certain conditions which varied from industry to industry. For example, British Telecom could legitimately refuse a request for supply if it was impracticable or not reasonably practicable to provide telecom service;³ British Gas Board was obliged to give a supply of gas if it was economical to do so;⁴ while Scottish electricity boards had to provide electricity services as far as it was practicable.⁵ Thus, different let-out clauses applied to different industries.

Privatisation would have been an ideal occasion to reconsider whether the universal service obligation should be qualified after the disposals and, if so, whether the same vague terms should be retained in the legislation. However, neither of these points received much attention: the new gas and telecommunications Acts simply repeated the relevant provisions of the nationalisation statutes. The same term ("economical") qualifies the obligation to supply under the Gas Acts of 1948 and 1986; and the same conditions ("impracticable or not reasonably practicable") appear in the British Telecommunications Act 1981 and in the Telecommunications Act 1984. These provisions were also mirrored in the licences issued to British Gas plc and British Telecom plc respectively. A new qualification was introduced in the electricity industry: "practicable" was replaced with the "reasonable in all the circumstances" condition.⁶ To conclude, the idea of universal services and the historical limits to the provision of such services "have in general been carried into privatisation".⁷

Thus, the *obligation side* of social contract did not change much after privatisation. Both nationalised and privatised utilities must now supply customers on request; the ownership of telecommunications, electricity, and gas companies is irrelevant to their being obliged to provide universal services. The obligation to supply is subject to the same exceptions under nationalisation and privatisation Acts. However, profound changes

occurred as far as *privileges* of the utility companies were concerned.

Farewell to monopoly

Statutory privileges arising from the original social contract were first altered under the Telecommunications Act 1984. Pursuant to this Act, a new supplier, Mercury Communications Ltd, began supplying telecommunication services as from 8 November 1984. Similar developments occurred in the gas and electricity sectors: alternative suppliers were licensed under the Gas Act 1986 and the Electricity Act 1989. Competition between privatised utilities and new entrants was limited immediately after privatisation. British Telecom plc had only one major competitor in 1984; while the newly licensed energy companies were authorised to supply customers consuming more than 25,000 therms of gas a year (monopoly threshold) or having a peak electricity demand greater than 1 MW (franchise limit). The historical importance of this embryonic competition is that, following privatisation, British Telecom plc, British Gas plc and the regional electricity companies had less privileges than their nationalised predecessors: they were perhaps *de facto* but certainly not *de iure* monopolies. Thus, one condition of social contract was gone: the privilege of statutory monopoly was abolished. Was the other condition (social obligations) also adjusted?

In relation to obligations, the main provisions of the new social contract may be summarised as follows:

- following privatisation British Telecom plc, British Gas plc and the regional electricity companies retained the obligation to supply;
- with the exception of electricity, the legislator did not amend the terms of the supply obligation: privatised utilities and their nationalised predecessors had the same "excuses" to refuse a request for supply; and
- new licensees were not saddled with supply obligations. The licence issued to Mercury Communications Ltd did not include the Universal Telecommunication Services condition.⁸ New market players need not bother about social obligations in the gas and electricity industry; the franchise limit/monopoly threshold barred them from supplying low-user, high-cost customers.

Economists seem to be content with this arrangement. They argue that the above outlined rules intend to forge competition, and the incumbent suppliers have great advantages "which do not offset the disadvantage of facing universal service obligations".⁹ This article is not concerned with the validity of that argument; it notes simply that privatisation statutes replaced the original model of social contract (monopoly rights *in exchange* for the obligation to provide universal services), with social contract no.2 (no statutory monopoly *but* obligation to supply). The main point is that rights and obligations do not appear to be balanced after privatisation: the privilege had been taken away (no monopoly rights); but the obligation remained intact (see above). Will a liberalised market rebalance rights and obligations?

Future of social contract

Will *liberalised* markets have a social contract? It is generally presumed that *free* markets would need no social contract. Some commentators conclude from this presumption that the obligation to supply may be abolished:¹⁰ such obligation would be "anomalous with the competitive market"¹¹ and would distort competition.¹² Professor Prosser dissents from this view by arguing that "... [the] social dimension to utility regulation has become absolutely central to regulatory performance and credibility" and "... [the] relationship between privatisation, regulation, and the provision of what are still widely seen as public services with a social dimension will be the key question of regulation in the next few years".¹³ Thus, two views may be observed in the literature: (1) the demise of social contract – the obligation to supply may be abolished; and (2) the rise of social contract – the future of supply obligations will be a key question of utility regulation.

Regulators did not stay aloof from the debate concerning the future of social contract. However, OFTEL, OFFER, and OFGAS do not have a uniform approach: the three offices seem to advocate three different views as to how social contract no.2 should be amended.

Telecommunications

The Director General of OFTEL does not intend to redraft social contract no.2 until 1999 at the earliest. In a recently issued

discussion paper, Don Cruickshank argues that "the current net cost involved in the provision of universal service in the UK is not proven and does not justify setting up a universal service funding mechanism in the short term".¹⁴ The Government agrees with the regulator: DTI informed the Select Committee on European Legislation that "the cost to BT and Kingston Communications of meeting their universal service obligation is likely to [be] very low or of a *de minimis* nature. As a result, it is possible that the UK may choose not to set up a universal service funding scheme in the immediate future".¹⁵ Thus, the universal service obligation, and its financial burden, if any, are to remain with British Telecom plc for the time being.

To conclude, rights and obligations have not been balanced in the telecom sector following liberalisation. British Telecom plc has no monopoly rights but must provide universal services. However, no new social contract will be drawn up in the near future. According to OFTEL there is no undue financial burden on BT arising from the universal services obligation.

Electricity industry

Second tier licensees are not subject to statutory supply obligations for the time being. In the run up to the liberalisation of the UK electricity market OFFER intends to modify social contract no. 2: after 1998 similar obligations will apply to the second tier suppliers which presently apply to public electricity suppliers. Condition 22 of the draft standard second tier electricity supply licence requires the licensee to supply domestic customers on request.¹⁶ As far as the financing of universal services is concerned, OFFER seems to be in complete agreement with OFTEL: no action is necessary for the time being. According to the Director General of OFFER, the public electricity suppliers alone should meet the costs of social services until 1998. The Office is currently considering what financing regime will be in place after that date. The preferred solution seems to be the introduction of a small levy which would be charged on customers.

Thus, proposed changes in the electricity sector seem to echo the original principles of social contract: rights and supply obligations will be balanced out. If second tier suppliers are to supply customers they must shoulder social obligations.

Gas industry

In the telecommunications and electricity industries the regulators attempt to adjust social contract no. 2 to the needs of liberalised markets; the legislator must now set out new social arrangements in the gas sector. While the basic principle is the same as in the electricity sector (i.e. each licensee must supply customers on request), a unique system is emerging under the Gas Act 1995.

Statutory obligation to connect

Public gas transporters are obliged to *connect* premises under s.4 of the Gas Act 1995. Compared with the Gas Act 1986, the scope of this obligation is broader in two respects: (1) transporters are to connect *any premises* (under the 1986 Act the obligation was only to supply premises which were (a) situated within 25 yards from the main or (b) connected to any such main) if the service pipe is supplied and laid, or proposed to be supplied or laid, by the owner or occupier; and (2) a customer may request a supply of gas up to 75,000 therms (under the 1986 Act this figure was up to 25,000) per annum. The obligation to connect is subject to the usual two-tier test, i.e. reasonable request and whether it is economical to supply.¹⁷ However, the Gas Act 1995 does not provide for a statutory obligation to *supply customers*.

New exceptions

Condition 2 of the Standard Conditions of the Gas Suppliers' Licences requires a licensee to supply every potential domestic customer who is connected to a relevant main. The Standard Conditions set a new exception to the obligation to supply. A licensee is not obliged to supply at new premises "if and so long as to do so would significantly prejudice its ability" to supply existing domestic customers.¹⁸ This new qualification does not appear to be more down-to-earth than the old (a) reasonable request and (b) economical to supply conditions. The Director General of OFGAS will be in an unenviable situation when she is called to interpret terms like "prejudice" and "ability".

Financing of universal services

OFTEL and OFFER do not appear to have definite plans on how universal services will be financed in the future; both Directors General are to review the current arrangement

(i.e. the costs of universal services fall on British Telecom plc and on the public electricity suppliers) in 1999 and in 1998 respectively. The Director General of OFGAS took the plunge: the Standard Conditions of the Gas Suppliers' Licences will revolutionise the financing of social obligations. If certain conditions are met, as set forth under condition 6(2) of the Standard Conditions of the Gas Suppliers' Licences, a licensee may make a special customer payment claim. Unless the Secretary of State or the Director General of OFGAS would decide that the claim is unjustified, the public gas transporter will (1) make a payment to the supplier and (2) in turn, increase its charges for the conveyance of gas.¹⁹ This arrangement will not be operative before 1999.

To conclude, rights and social obligations will be rebalanced in the gas industry, each licensee having (1) the right to supply any customer and (2) the obligation to provide universal service. A special funding scheme is due to be introduced in the British gas industry to finance the costs of universal services.

The European dimension

If the three above-mentioned regulators do not agree on the financing of universal services in Britain, the 15 member states of the European Union do not really have a better prospect of forming a uniform position on the same matter. The first and most important problem at European level is that "neither the concept nor the scope of the [public service] obligations is in any way harmonised between the member states".²⁰ A prolonged debate concerning the future of the social contract could thwart the liberalisation of the EU telecom, electricity, and gas markets. Therefore, the relevant directors try to say as little as possible about public service requirements.

The first telecom Directive 90/388/EEC was reticent about social obligations. Principles of universal services were first set out in a Council Resolution 94/C 48/01, and Directive 96/19/EC laid down rules in connection with the financing of universal services. This Directive states that the national regulatory authority is to determine whether or not a universal service financing scheme is required. If such a scheme is introduced it must operate in accordance with Community law; the

Commission is to review the financing schemes no later than 1 January 2003. OFTEL decided that universal service funding is not required in the United Kingdom for the time being; thus, Community law on financing schemes does not apply to British telecom operators.

The recent electricity Directive 96/92/EC, and the draft natural gas Directive (COM(93) 643 final) do not discuss social obligations in detail. Although the Economic and Social Committee stressed that "the 'public service' obligations of these sectors cannot be overlooked"²¹ the documents listed declare merely that member states may impose on distribution companies an obligation to supply. Hence, the electricity Directive does not appear to require further action from the UK Government. The two cornerstones of the proposed system (obligation to supply will extend to every supplier, while financing of universal services will not be reformed until 1998) are consistent with Community law. Attention is now focused on the natural gas proposal. The latest draft seems to mirror the electricity Directive; thus, the gas Directive will have limited impact in the United Kingdom. The Standard Conditions of the Gas Suppliers' or Transporters' Licences are likely to satisfy the EU requirements as set forth in the draft natural gas Directive.

However, the electricity Directive and the draft natural gas Directive may not be the last documents from the European Union on social contract: the Economic and Social Committee noted that "... the present proposals represent a compromise which will have to be fine-tuned as the proposed process of aligning the operating conditions in both sectors progresses and as experience is acquired in operating the internal market in these sectors under these conditions".²² As a result of "fine-tuning" a European social contract is likely to emerge in the electricity and natural gas sectors; details of that arrangement are not available for the time being.

The EU position on social obligations may be summarised as follows: (1) as a rule, directives do not discuss public service obligations in detail; (2) Community law on the financing of universal services in the telecom sector does not apply in the United Kingdom. OFTEL decided that no financing scheme is required; and (3) the OFFER proposal for the liberalisation of the UK electricity market harmonises with the electricity Directive. The

proposed natural gas Directive is likely to have limited impact in the UK gas sector.

Conclusion

The original model of social contract intended to balance out supply obligations and monopoly rights. However, rights and obligations do not go hand in hand after privatisation. Statutory monopoly of the incumbent telecom, electricity and gas suppliers was abolished but, nevertheless, they must still provide universal services (social contract no.2). This article has tried to argue that a third generation of social contract will govern liberalised markets: market players may supply *any* customer but must provide services to *all*.

JOSEPH BALOGH

1. Gas Act 1972, s.29.
2. C. Foster, *Privatisation, Public Ownership and the Regulation of Natural Monopoly* (1992), Blackwell, p.78.
3. British Telecommunications Act 1981, s.3(1).
4. Gas Act 1972, s.2.
5. Electricity (Scotland) Act 1979, s.3(2).
6. Compare s.(3)(2) of the Electricity (Scotland) Act with s.17(2)(c) of the Electricity Act 1989.
7. C. Foster (n.2 *supra*), pp.111 and 292.
8. Compare condition 50 of the Mercury licence with condition 53 of the British Telecom licence.
9. Philip Cullum, *Consumer Rights for Utility Services* in: *Centre for the Study of Regulated Industries: Universal Service Obligations: A Policy Review* (1996), p.10; OFFER, *The Competitive Electricity Market from 1998: Customer Protection, Competition and Regulation* (November 1995), p.8, point 3.8.
10. A. Holmes, *Privatising British Electricity* (1992), FT Business Information, pp.116–117.
11. Dow, "Licensing of the Gas Supply Industry under the Gas Act 1995" [1996] 7 Util LR 31 at 34.
12. OFFER (n.9 *supra*), p.5, point 2.17.
13. Prosser, "Utilities and Social Regulation" [1994] 5 Util LR 156.
14. OFTEL, *Universal Telecommunications Services. Proposed Arrangements for Universal Service in the UK from 1997* (1997).
15. Select Committee on European Legislation, Sixteenth Report, 14. *Telecommunications: Financing of Universal Service*, HC 36-xvi 1996–97, section 14.7.
16. OFFER, *The Competitive Electricity Market from 1998. Standard Second Tier Electricity Supply Licence (for Scotland) Draft* (January 1997).
17. Gas Act 1986, s.9(1)(b), as amended by Gas Act 1995, s.3.
18. Condition 7(3) of the Standard Conditions of the Gas Suppliers' Licences.
19. Condition 10(1)(a) of the Standard Conditions of the Gas Transporters' Licences.
20. Opinion from Economic and Social Committee on common rules for the internal market in electricity and natural gas (94/C 195/24) (OJ 1994 C195/82).
21. Opinion from Economic and Social Committee on common rules for the internal market in electricity and natural gas (93/C 73/10) (OJ 1993 C73/31).
22. Opinion from Economic and Social Committee on common rules for the internal market in electricity and natural gas (n.20 *supra*).

Appendix 2.

one of quasi-criminal offences and penalties, with investigatory powers for the first tier competition authorities backed up by the possibility of private civil actions. This is likely to be a significant change, particularly in the light of full competition in the domestic energy markets. The possibility of private actions, for example from Cable TV customers claiming damage from anti-competitive practices by BSKYB,¹ raises some novel legal problems, but also creates an incentive on the company accused of breach of the prohibition to fight the case through all the appeal procedures. Much will depend on the attitude taken by the competition tribunals to

the Director's initial decision and to the courts' view of their own appeal function, given that the division between law and facts is notoriously messy.

The decision to give the sector regulators concurrent powers under this new legislation also raises the possibility of their developing into sectoral competition regulators—which seems to be the ambition of some of them.

COSMO GRAHAM

1. My thanks for this idea to Martin Cave.

A Economic Analysis of Making Applications for Judicial Review

The utilities sector has experienced an upsurge in the number of judicial review applications over the last few years. One of the most important questions now is whether the number of applications will increase further. It may be useful, therefore, to discuss what points applicants are likely to consider before turning to the courts for help. Potential applicants are expected to challenge the validity of regulatory orders if certain conditions are fulfilled: the main point of this article is that a simple, perhaps oversimplified, mathematical formula may summarise such conditions. It will be argued below that (i) potential applicants may be divided into two groups; (ii) licensees and customers have different incentives to seek judicial review; and (iii) the latter may find it easier to appeal to the courts for the time being.

Introduction

It has long been recognised that there is an economic dimension to making applications for judicial review. As a rule, practitioners making such applications are cost conscious and frequently weigh up the pros and cons in economic terms. Three examples might suffice here.

1. The Public Law Project advocated the introduction of a pre-litigation questionnaire in 1996 arguing that it would reduce "costs risk for applicants".¹
2. Legal aid applications are decided on the basis of a cost-benefit analysis. According

to the *Legal Aid Notes for Guidance* (1995), no aid will be granted "if the proceedings are not likely to be cost effective, i.e. the benefit to be achieved does not justify the costs".

3. A practitioner argues that making submissions at the application stage is a cost-saving device for the respondent. He attends and makes submissions "in the hope of saving his own future costs which will be incurred if leave is granted".²

Thus, practising lawyers are not deaf to economic considerations and they do make a brief economic analysis before applying for judicial review.

As far as the economic analysis of law is concerned, judicial review of *regulatory orders* is an especially promising research theme. Economics and law intertwine in utility regulation. Economic concepts, like cross-subsidy ("Hydro Benefit" in Scotland) or cost-benefit analysis (see *R v National Rivers Authority ex p. Moreton* (below)), are transplanted to a legal environment here. Hence, the economic analysis of law may help to understand under what circumstances potential applicants will seek judicial review.

Introduction of economic model

The economic approach to judicial review would deal first with the applicants, followed by the application of a formula.

Applicants

The starting-point is that the number of applicants is not fixed in advance: any interested party may apply for judicial review against a regulatory decision.³ As a rule, two groups of applicants exist: licensees and customers. The latter group includes (a) customers of utility companies and (b) pressure groups.⁴ The economic approach to judicial review assumes that the difference between the behaviours of (a) and (b) is marginal; hence, this group will be referred to as customers.

It is further assumed that customers (1) always have a free choice whether or not to apply for judicial review; and (2) are rational profit maximisers when opting whether or not to apply. Tactical challenge is excluded.

The formula

If (1) and (2) are simultaneously assumed then applicants will seek judicial review if:

$$(P_{app} - P_{reg})R_{app} > C_{app}$$

where

P_{app} = probability that judicial review will be granted as estimated by the applicant;
 P_{reg} = probability that judicial review will be granted as estimated by the regulator;
 R_{app} = remedy as valued by applicant; and
 C_{app} = costs incurred by the applicant.⁵

In the discussion below probability, remedy and cost will be expressed as either low or high. The reason for preferring "low-high" to figures is discussed below. Numbers are not indispensable. As Professor Richard Posner notes, the economic analysis of law "need not be conducted at a high level of formality or mathematisation. The heart of economics is insight rather than technique".⁶

Application of formula

Few regulatory orders were impugned between 1984 (when OFTEL was established) and 1997. The Trade and Industry Committee noted that "there have been few judicial reviews" in the utilities sector.⁷ This means that more often than not the left-hand side of the formula is *smaller* than C_{app} ; thus, potential applicants do not challenge regulatory orders before the court. Why is this so? To answer that question the three elements of the formula should be analysed in some detail.

Applying the above formula to:

R v Director General of Gas Supply and another ex p. Smith and another (Lexis, 31 July 1989), QBD;

R v Director General of Electricity Supply ex p. Redrow Homes (Northern) Ltd (Lexis, 3 February 1995), QBD;

R v National Rivers Authority ex p. Moreton (Lexis, 13 September 1995), QBD;

R v Director General of Rail Franchising ex p. Save Our Railways (Lexis, 15 December 1995), CA;

Mercury Communications Ltd v Director General of Telecommunications and another [1996] 1 All ER 575, HL;

In the matter of Applications by Sherlock and Morris for Judicial Review (Lexis, 29 November 1996), QBD;

R v Director General of Telecommunications ex p. British Telecommunications plc (Lexis, 20 December 1996), QBD;

R v Director General of Electricity Supply ex p. Scottish Power plc (Lexis, 3 February 1997), CA

three conclusions would follow.

Probability

It is a well-known fact that the vast majority of applications in Britain fail. It is more likely than not that the original regulatory order will not be quashed. As far as the above list is concerned, judicial review was granted in *Smith*, *Redrow Homes*, *Save Our Railways* and *Scottish Power* i.e. four out of 10 cases. The overall picture is no more promising: (a) no judicial review against decisions of the Takeover Panel has succeeded so far; and (b) 6.4 per cent of the total number of applications for judicial review against decisions of the Home Office were successful between 1991 and 1996.⁹ Hence, P_{reg} is high, and regulators may be optimistic that the court will not set aside regulatory orders challenged.

P_{app} tends to be low. An applicant may never be sure whether his application will be successful. The point is that judicial review jurisdiction is discretionary;¹⁰ it is up to the court whether judicial review will be granted. Thus, applicants should proceed with caution when estimating the probability that judicial review will be granted. In *Sherlock and Morris*, although Kerr J found that "the applicants are, prima facie, entitled to have the decisions of NIE quashed", he did not "accede to the applications for judicial review".

If P_{reg} is high and P_{app} is low then ($P_{app} - P_{reg}$) will be low, and must be low otherwise disputes between regulators and regulatees would not be negotiated but referred to the court.

Remedy

It may be useful to make an introductory point here. R_{app} should not be confused with the monetary value of claims, for two reasons:

1. The monetary value of certain claims may not be established. The *Moreton* case is a good example. Ms Moreton is "a regular swimmer in the sea at Tenby"; she was concerned "about the effect of the increased effluent discharge ... on the quality of the bathing water where she swims". What was the monetary value of R_{app} in this case? The formula set out above presumes that Ms Moreton had a positive R_{app} in her mind, otherwise she would not have applied for judicial review. If R_{app} is zero or negative the lefthand side of the formula would be smaller than C_{app} ; hence, Ms Moreton would not have applied for judicial review. But it is pure guesswork to express R_{app} as hundreds or thousands of pounds now. Thus, the economic analysis of judicial review might run into practical difficulties if R_{app} were the monetary value of claims;
2. If R_{app} stands for the sums of money at stake, it would simply reflect the well-known fact that licensees have bigger financial muscles than their customers. For example, the applicant reckoned in the *Scottish Power* case that an additional £40 million revenue may be collected until the next price review (1998) if the application for judicial review were granted. On the other hand, a gas customer was suing for as little as £198.19: Pill J himself commented in the *Smith* case that "the sum of money involved is not large". The point here is that if R_{app} were the same as the value of claims it would always be high for licensees and low for customers. However, R_{app} has a more complex role to play in the formula.

It should be recalled that R_{app} was defined above as remedy *as valued by applicant*. The economic analysis of law would underline that applicants consider two factors in deciding whether to seek judicial review: (1) lawfulness; and (2) action. The two terms

and the difference between them may be explained as follows:

Lawfulness

All the cases listed above may be reduced to a YES–NO binary code: either the regulator's decision is legally "respectable" or it is not; either he complied with a direction given to him by the Secretary of State or he did not (see the *Save Our Railways* case); either he has the power to make certain licence modifications or he has not (see the *British Telecom* case); either he must determine a dispute referred to him or he must not (see the *Redrow Homes* case); etc. The economic analysis will refer to this YES–NO point as lawfulness. It is the classic domain of judicial review jurisdiction. Judges are well placed to make decisions about the lawfulness of regulatory orders; but lawfulness is not the full story in the regulatory game – the emphasis is on action.

Action

If lawfulness has been decided in favour of the applicant, the "And what's next?" question will arise. A new regulatory order will be issued in accordance with the judgment of the court, which will spell out action. The link between (a) judgment and (b) action is of crucial importance. Applicants may not worry about the lawfulness of a regulatory decision if, and so long as, it does not harm their economic or other (e.g. *Moreton*) interests. They would like to know what actions will follow once the regulator's decision has been quashed. Thus, applicants want judicial review to cover lawfulness *and* action.

The point here is that applicants are looking for remedies that address both lawfulness and action. Six kinds of orders may be granted: (1) the "trilogy of prerogative orders" (*certiorari*, *mandamus* and prohibition); (ii) declaration; (iii) injunction; and (iv) damages.¹¹

Declaration and *mandamus* would be the best choices, perhaps determining what action the regulator will take. It is no surprise, therefore, that these orders are popular among applicants. Declaration was sought in, for example *Smith*, *Scottish Power*, *British Telecom* and *Mercury*. The courts have full discretion as to the form of judgments under British administrative law. Judges tend to keep their involvement in the regulatory game to the minimum: they are willing to set aside the original resolution but other remedies may not be

granted. The best examples are *Scottish Power* and *Smith* in which the original regulatory decision was quashed but no further orders were made, although the applicants were seeking other remedies. This is unsatisfactory in that judicial review settles lawfulness but the judgment is likely to be reticent about action. As a rule, *certiorari* or a "remission with a direction to consider"¹² does not determine what action the regulator will take. It is for the regulator to reconsider the matter impugned – he is the decision-maker.

There are exceptions: *certiorari* may point to the only legally acceptable action in certain cases. Once the court has ruled in favour of the applicant on lawfulness, the course the regulator "should lawfully take will often be obvious".¹³ For example, the applicants were disconnected in *Smith* and *Sherlock and Morris*. If judicial review is granted, it is likely that they will be reconnected. As a rule, *certiorari* may determine action when applicants are complaining about a *past* grievance, e.g. disconnection, payment of excessive connection charge (*Redrow Homes*) etc. However, licensees apply for judicial review so as to influence *future* regulatory actions. For example, Lord Slynn commented in *Mercury* that the plaintiff was "seeking to clarify position for *future* negotiation and determination". The *Scottish Power* case is another example; although it was a challenge against the currently operational price formula, *Scottish Power's* main worry was not the 1994/95–1997/98 period. What the applicant tried to achieve was that the September 1994 price proposals, which retained the total market definition of GBY, would not "set a precedent for *future* regulatory reviews". The setting-aside of the original decision will not satisfy licensees in the cases mentioned above. As was noted above, the order of *certiorari* is reticent about action: the Director General may come to the same decision he previously made.¹⁴ For example, the Director General of Telecommunications made it clear in *Mercury* that he adhered to his original determination. *Certiorari* would not have been a useful order in this case. Thus, licensees want judicial review to go beyond lawfulness: judgments should address action.

Judges disagree. As Sir Thomas Bingham MR put it in the *Save Our Railways* case, "our task begins and ends with review of lawfulness of what has been done". Schiemann J made the same point in *Redrow Homes* noting that "the point [raised by the applicant] is one of pure statutory construction". As a rule, the

courts confine their attention to lawfulness: judges try to steer clear of action. Thus, judges prefer *certiorari* to declaration, and they may impose their preferences on potential consumers. As was mentioned above, judges have full discretion as to the form of order(s) to be granted: the application may be for *mandamus* and declaration, but the court may issue an order of *certiorari* (see the *Smith* and *Scottish Power* cases).

What does this mean in terms of the formula? The main point is that licensees and customers have different views about remedy. As far as licensees are concerned, R_{app} will be high if judicial review deals with both lawfulness and action. Declaration or *mandamus* would be ideal remedies, indicating what action should follow once the original order has been quashed on the ground of lawfulness. Thus, R_{app} will be high if declaration or *mandamus* were likely to be granted. However, judges have a *certiorari*-friendly policy; they intend to limit their involvement to lawfulness – action is not their concern. This judicial approach devalues R_{app} . Hence remedy will be low for licensees, who cannot predict from the decision on lawfulness what action the regulator will take.

As far as customers are concerned, the *certiorari*-friendly policy is less problematic: an order to quash may point to the only acceptable action. Remedy may therefore be high for customers. The importance of this point will be apparent below.

Costs

It is common knowledge that judicial review is costly. Potential consumers will incur hefty expenses – it cost on average £50,000 to bring a judicial review case in 1995.¹⁵ In addition to legal expenses, judicial review also tends to increase the overall costs of regulation.

A consensus-driven system of utility regulation operates in the United Kingdom. An application for judicial review flies in the face of the "negotiate but do not litigate" principle. Dragging a Director General to court will rearrange relations between regulators and regulatees – a phenomenon known as "juridification". Increased judicial review will slow down the regulatory machinery,¹⁶ which is bad news for the regulatees as regulation will be more time consuming and, consequently, more expensive. Thus judicial review is likely to put regulatory costs up.

This point does not apply to the other group of consumers. Unlike licensees, customers do not negotiate with regulators on a day-to-day basis. The fact that the regulatory process may slow down does not disturb them. As such, the increase in regulatory costs is not a cause for concern for customers. Furthermore, some customers may receive state aid when challenging the validity of regulatory orders. For example, the Smiths and Ms Sherlock were dependent on DHSS benefit and were presumably on legal aid; judicial review was available on a free-of-charge basis in the *Smith* and *Sherlock and Morris* cases.

The final point is that the more applications for judicial review there are, the more expensive utility regulation will be. Cost is likely to go up. Licensees will get the lion's share of regulatory costs as they will have high C_{app} ; but C_{app} is low for customers. In fact, some customers may get legal aid to impugn the validity of regulatory orders.

Conclusion

The main points of this article may be restated briefly. (1) Probability tends to be low for applicants. (2) Remedy would be high if orders other than *certiorari* were granted.

For the time being R_{app} is low for licensees as judges pursue a *certiorari*-friendly policy. The granting of other prerogative orders or declaration are more the exception than the rule. (3) Cost is high for licensees and low for customers.

According to the formula set forth above, potential consumers will opt for judicial review if $(P_{app} - P_{reg})R_{app}$ is greater than cost. As was mentioned above, probability is low, and will remain so; high P_{app} would open the floodgates for judicial review applications. Hence, the left-hand side of the formula may be bigger than C_{app} if (i) remedy is high, or (ii) cost is low.

The final points, therefore, are:

Licensees – cost is high. Thus, they will only apply for judicial review if remedy is

high. However, R_{app} is actually low, and *certiorari* is the preferred form of order. Remedy would be high for licensees if *mandamus* or declaration were granted more frequently.

Customers – cost is low, and remedy is high here. Customers are usually complaining of past grievances which an order to quash may redress effectively.

The economic analysis would conclude that the *certiorari*-friendly policy may discourage licensees from seeking judicial review, who would have more incentives to turn to the court for help if judges were inclined to make orders of *mandamus* and/or declaration. The judiciary's practice concerning the form of orders granted will influence the future number of applications for judicial review.

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1. Stephen Cragg, "The PLP's Pre-Litigation Questionnaire" [1996] JR 71.
2. Mark Shaw, "Costs at the Leave Stage" [1996] JR 8.
3. House of Commons Trade and Industry Committee, *Energy Regulation*. 1996–97, HC 50-I, para.169, p.lix.
4. In relation to the standing of pressure groups to seek judicial review, see Kris Gledhill, "Standing, Capacity and Unincorporated Associations" [1996] JR 67.
5. For background to the formula, see Richard A Posner, *Economic Analysis of Law* (Little, Brown and Company, 1992) para.21.5.
6. Richard A Posner, "The future of Law and Economics Movement in Europe" (1997) *International Review of Law and Economics*, 17, 3–15 at 14.
7. House of Commons (op. cit. n. 3), para. 169.
8. Hansard, Written Answer, HC Debs, 16 July 1997.
9. Peter Cane, *An Introduction to Administrative Law* (Clarendon Press, 1996), p.70.
10. Michael Fordham, *Judicial Review Handbook* (John Wiley & Sons, 1997), para.24.1.
11. Richard Clayton and Hugh Tomlinson, *Judicial Review Procedure* (John Wiley & Sons, 1997), para.3.2.3.
12. *Ibid.*
13. Michael Fordham (op. cit., n. 11), at para. 4.1.3.
14. *Independent*, 2 August 1995.
15. Colin Scott, "The Juridification of Regulatory Relations in the UK Utilities Sector" (unpublished paper, 1997), p.29.